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Notes on the Liberal Constitution

James M. Buchanan

No existing or proposed political constitution contains sufficient constraints or limits on the authority of the agencies of government over the activities of individuals and groups, and most notably over their economic activities. There is no *liberal* constitution in existence or in prospect. In this sense, all existing constitutions are failures, and almost all serious proposals for reform fall short of any promise of full success. I advance this blanket criticism of existing and proposed constitutional structures without knowledge of particular details but in full and conscious awareness of the historical fact that, for well over a century, all political discourse has been informed by, and the institutional results thereby influenced by, the "fatal conceit" (Hayek 1989) that political direction can facilitate rather than retard economic progress. All constitutions that have been put in place since the 18th century, and all that have been "reformed" either explicitly or by usage and interpretation since that time, must reflect, to some degree, the romantic image of the benevolent state, whether actual or potential, the image that was introduced by the political idealists on the one hand and by the visionary socialists on the other.

The constitution that embodies "politics without romance" (Buchanan 1979) exists nowhere today, and no reform proposals that reflect such a realist model of politics enter directly into any ongoing dialogue. Residues of such a vision may be found only in some of the Madisonian elements that remain in the United States documents and records, and in the arguments of the relatively small number of classical liberals now extant. Despite this negative assessment, which may seem to be nearly total in its condemnatory sweep, there may be bases for some optimism as we look far enough forward into the

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post-revolutionary epoch, and especially into the next century. Ideas do have consequences, and we have lived with the consequences of false ideas for almost two centuries, far too long to have expected shifts to occur by the early 1990s. But consequences, or rather events, also feed back on ideas, and, after the unpredicted revolutions of 1989-91, the romantic image of the benevolent and capable state must prove increasingly difficult to sustain. The theories of political failure, advanced sparingly by classical liberals throughout the period of socialist hegemony only to have been treated with scorn and derision, have been corroborated by history in what was perhaps the grandest of all experiments in social science. And unless we totally despair of human capacity for rational action, we must anticipate that, sometime in the post-socialist century, men and women will exhibit constructive constitutional capabilities that can now be scarcely imagined.

In this sense, Francis Fukuyama (1992) is surely right. Call it what one will, something of historical note did effectively end with the great revolutions of 1989-91. And Fukuyama is also correct in suggesting that economic science, which explains how the market economy operates independently of politicized direction and control so as to produce the largest bundle of goods and services available within given resource constraints, has finally been vindicated. But is Fukuyama also right when he predicts that this scientific result will be incorporated into institutional-constitutional reform? To agree with him here, we perhaps must think beyond the horizon of a few decades.

As a start, it may be useful to extend our hindsight into the pre-romantic, pre-socialist epoch, back to the 18th century, and to try to recapture the constitutional understanding that so excited the philosophers as well as the politicians. Until and unless such a shift in the modern mind-set is somehow achieved, all efforts at constitutional dialogue aimed at basic reform will essentially be wasted. Governments, no matter how organized, will remain basically unchained, and the politicians-bureaucrats will continue to facilitate the mutual exploitation of each by all, in Anthony de Jasay's "churning state" (1985). Economies will founder, and, increasingly, potentially valued product will disappear into the "black hole" of that which might have been (McGee, Brock, and Young 1989).

The Constitutional Order of Classical Liberalism

The classical liberals of the 18th century, whether represented by the members of the Scottish Enlightenment or by the American Founding Fathers, were highly skeptical about the capability and willingness of politics and politicians to further the interests of the

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ordinary citizen. Governments were considered to be a necessary evil, institutions to be protected from, but made necessary by the elementary fact that all persons are not angels (Madison 1966[1787]: 160). Governments, along with those persons who were empowered as their agents of authority, were not to be trusted. Constitutions were necessary, primarily as means to constrain collective authority in all of its potential extensions. State power was something that the classical liberals feared, and the problem of constitutional design was thought to be that of insuring that such power would be effectively limited.

The devices aimed to accomplish this purpose are the familiar ones. Sovereignty was split among several levels of collective authority; federalism was designed to allow for a deconcentration or decentralization of coercive state power. At each level of authority, separate functional branches of government were deliberately placed in continued tension, one with another. In some polities, the dominant legislative branch was further restricted by the constitutional establishment of two bodies, each of which was organized on a separate principle of representation.

It is important to recognize that these basic organizational-procedural elements of political constitutions were designed, discussed, and put in place by the classical liberals within the context of a shared aim or purpose, which was that of checking or constraining the coercive power of the state over individuals. The motivating force was never one of making government "work better" in the accomplishment of some arbitrarily selected "public good," or even one of insuring that all interests were somehow "more fully represented."

The organizational-procedural elements of the classical liberal constitution, those listed above and others, were deemed to be less important than those provisions that laid out the range and scope of activities that were appropriately to be undertaken by collective authority. That is to say, the constitutional instructions as to what governments might and might not do were always considered to be much more important than how governments do whatever it is that they, in fact, do. This critical distinction, which was central to the whole classical liberal conception of social order, was essentially lost to the public consciousness during the ascendency of electoral democracy, especially during the 19th and 20th centuries. There was generalized acceptance of the fallacy that equated the emergence of electoral democracy with a reduced need for explicit constitutional constraints on the range and scope of governmental activity.

In the classical liberal constitutional order, the activities of government, no matter how the agents are selected, are functionally restricted to the parameters for social interaction. Governments, ideally, were

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to be constitutionally prohibited from direct action aimed at "carrying out" any of the several basic economic functions: (1) setting the scale of values, (2) organizing production, and (3) distributing the product. These functions were to be carried out beyond the conscious intent of any person or agency; they were performed through the operation of the decentralized actions of the many participants in the economic nexus, as coordinated by markets, and within a framework of "laws and institutions" that were appropriately maintained and enforced by government.

This framework-maintenance role, properly assigned to government in the classical liberal order, included the protection of property and the enforcement of voluntary contracts, the effective guarantee of entry and exit into industries, trades, and professions, the insured openness of markets, internal and external, and the prevention of fraud in exchange. This framework role for government also was considered to include the establishment of a monetary standard, and in such fashion as to insure predictability in the value of the designated monetary unit. (It is in this monetary responsibility that almost all constitutions have failed, even those that were allegedly motivated originally by classical liberal precepts. Governments, throughout history, have almost always moved beyond constitutionally authorized limits of their monetary authority.)

A central principle inherent in the classical liberal constitution dictated that, regardless of what governments do, and whether or not collective activities are contained within the indicated limits, all persons and groups are to be treated equally. The generality principle, applicable to the law, was to be extended also to politics. There was no role for governmental action that explicitly differentiated among separate factions or classes of persons. In the classical liberal conception, successful majority coalitions could not impose differential taxation on members of political minorities, even for purposes of "doing good" (Buchanan 1992).

The Constitutional Order of Socialism

The classical liberal vision of a constitutional order did not command widespread public and philosophical acceptance for more than the several decades that straddled the turn between the 18th and 19th centuries. In small part, the reaction against this vision was due to the zealotry of those advocates who extended the central laissez-faire precept too enthusiastically, even to the rejection of a collective-governmental role in setting the parameters for economic interaction. But, primarily, the reaction against classical liberalism stemmed from

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the generalized unwillingness of participants in the body politic to accept the spontaneous allocative and distributive results generated in the operation of a market economy. These results were not taken to be "natural"; they were not understood to be the working out of the whole complex of separated choices made by persons in their many capacities. The results of market process were taken to be "artifactual"— produced rather than emergent, and hence subject to direct manipulation, change, and redirection by politicized collective action.

The reaction against classical liberalism was specifically stimulated and fueled by two separate sources. First, the genius of Karl Marx lay in his ability to isolate, identify, and publicize those elements in the operation of market capitalism that seemed most open to criticism, especially in the intellectual context of an incompleted classical economic theory, along with prevailing confusion as to the distinction between constitutional and within-constitutional operations of governments. Marx concentrated on the vulnerability of capitalism to financial crises, on the tendency toward concentration in industry, and on the alleged distributive exploitation of the proletariat. Secondly, political idealists for many centuries had implicitly used models of the state that involve presumptive benevolence and omniscience. Any failures of markets could, under this presumption of the idealized collectivity, be fully corrected by directed political action. The generalized Marxist critique, along with the presumption of idealized political governance, essentially destroyed the intellectual-scientific basis that had been constructed in justification of the classical liberal constitutional order.

From the middle of the 19th century, some vision of a socialist order emerged to capture, in varying degrees of enthusiasm, the minds of persons in all developed societies, even in those societies where Marxism, as such, was able to secure relatively little direct support. At base, the socialist vision categorically rejected the classical liberal conception of a self-regulating economy that operates within a set of constitutional limits enforced by government which, in turn, is itself limited largely, if not totally, to the enforcement role. And, if the self-regulating, or nonpoliticized, economy is rejected as the basic organizing principle, the controlled or regulated economy becomes a necessary component of any alternative model for social organization. This shift from the self-regulating model of an economy to that of a controlled or regulated economy may be, but need not be, directly related to issues that involve organizational-procedural changes involving ways and means that agents and agencies of governance are selected, along with constitutional dictates concerning how the control and regulatory functions are to be performed.

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The socialist constitutional order, whether this be defined in application to a single party, a self-appointed authoritarian regime, or a social democratic parliamentary majority, necessarily extends the range and scope for politicization well beyond the narrowly defined limits of collective authority under the classical liberal order. If the whole economy is opened up for control and regulation "in the general interest," there can be, by definition, little or no prior constitutional constraint on the definition of what such interest is by those agents and agencies charged with the responsibility for allocative and distributive results. Whereas governments in a classical liberal constitutional order have only a limited responsibility for the results that emerge from the interaction of persons in many capacities, governments in the socialist constitutional order have full or total responsibility for all results, including the size, composition, and the distribution of the "bundle of value" generated in the whole system. This ultimate responsibility remains with government even if the market, as a means of organization, is allowed to operate without detailed direction over wide areas of interaction. In the socialist model of government, there is, and can be, no constitutional guarantee offered to economic actors, whether persons or firms, against politically generated intrusions into liberty of commerce, whether this be marginal or total. In a genuine sense, with reference to the structure of the economy, the very term "socialist constitution" is oxymoronic. At best the constitutional order of socialism embodies constraints only on the procedures of politics and the behavior of political agents in carrying out those procedures; it cannot extend to include constraints on politicization of the economy, as such.

As we now know, as we have been informed by the great revolutions in central and eastern Europe in 1989-91, as well as by the cumulative historical experience from other parts of the world, as supplemented by analytical argument, the central principle for socialist order is fatally flawed and has been from the outset of its promulgation. The presumption that politicized control-regulation of economic relationships can, and will, generate a satisfactorily large bundle of goods and services, as valued by participants themselves, has been shown to be grounded in fallacy. In sum, the grand socialist experiments of the century did not work, and improved variants on these experiments cannot work, given the motivational, epistemological, and imaginative limits of the human animal. There is now generalized acceptance of the proposition that only market organization of the economy, which exploits the human potential, can produce an acceptably adequate aggregate of economic value.

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The Post-Socialist Constitutional Contradiction

The set of public, professional, political, and philosophical attitudes that seem most descriptive of the immediate post-socialist years of the 1990s is internally contradictory. The socialist vision of politicized control-regulation of economic interaction has by no means been exorcised from the modern mind-set despite the evidence from reason or from history. The belief that persons, acting jointly through their membership in collectivities, can effectively "improve" on the spontaneously generated outcomes of market processes remains imbedded in the modern psyche. Despite the overwhelming strength of the evidence, and despite supporting argument, persons cannot readily acquiesce in the stance suggested by post-socialist reality. The romance of socialism, which is dependent both on an idealized politics and a set of impossible behavioral presuppositions, has not yet disappeared.

Whether or not the romance will, in fact, fade away as we move further beyond the post-revolutionary turbulence of the 1990s and into the next century, cannot be settled outside futuristic speculation. Several questions may be posed: Will truth finally triumph over romance? Will the constitutional order of classical liberalism return, in some form, and come to command acceptance as the only order that combines personal liberty and economic prosperity? Will the public's interest in aggregative economic growth, in economic progress itself, finally carry the day and be reflected in genuine constitutional reforms? Or, may we expect the emergence of some new ideology that will offer renewed sustenance to a romantic image of collectivized utopia? Without the emergence of such an ideology, can we expect public acquiescence in authoritarian grabs for power? Without some equivalent of the Marxist class struggle as an ideological crutch for sloganeering, can the politicians escape skeptical censure by the public, even if there is little understanding of the functioning of the market? Is some tacit knowledge of constitutionalism likely to surface as the 21st century approaches?

The politics of my own country, the United States, in 1993 does not offer much basis for short-term optimism in putative response to these questions. The rhetoric of class warfare is now used to generate support for an enlargement of the already swollen governmental sector of the economy, and the provisional skepticism of the 1980s about the efficacy of regulatory efforts seems to have been replaced by reversion to nostrums of a half-century past. "Socialism in the small" is on the ascendency, as if the demise of "socialism in the large" is totally irrelevant. Politics aimed at "improving" on the outcomes of market processes is presumed capable of succeeding, despite the working of the selfsame incentive incompatibilities, knowledge limita-

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tions, and entrepreneurial disregard that produced the background for the great revolutions of 1989-91.

As noted earlier, if we are to find grounds for constitutional hope, it may be necessary to extend our sights, both temporally and locationally. We must recall Keynes' insistence on the long-range influence of ideas. Perhaps the post-socialist period is simply too short for us to have expected shifts in public and political attitudes, and especially in those societies that did not themselves go through the revolutionary upheavals. Perhaps any rebirth of classical liberalism must be expected to occur in those societies that did indeed suffer the revolutions; perhaps only in those countries has there been a sufficient loss of belief in politics and politicians to allow some reconstruction of the 18th century ideal of constitutional order. Only one prediction seems safe here. The constitutional prospect for the next century will be one of surprises.

Conclusion

I have discussed only briefly the whole set of constitutional issues that involves organizational and procedural alternatives of governance. I have not addressed such issues as republican versus parliamentary forms of government; proportional representation versus two-party structures; effective federalism versus political centralization. But my neglect of these issues has been quite deliberate. All such organizational-procedural matters fade into insignificance by comparison with the constitutional challenge of placing constraints on the authority of government over the operation of the economy. Until and unless the government is severely constrained in its economic overreaching, along more or less classical liberal principles, including the principle of generality, the particular choices made among the organizational and procedural alternatives becomes relatively insignificant.

A democratically elected parliamentary majority imbued with socialist ideas and vision can destroy the potential value that might be forthcoming from an unfettered market economy as much or more than the activities of an authoritarian regime. To the extent that constitutional constraints do effectively limit governments in their regulatory, financial, and taxing powers, the particular constitutional form for governance itself assumes secondary rank. To the extent that the powers of government remain open-ended and nonconstrained, the forms of government may seem to matter. But in some final sense, the overextended politics must surely fail, regardless of structural particulars.

In almost all countries, the continuing dialogue and discussion is centered on the establishment, maintenance, and preservation of

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"constitutional democracy." My central argument may be summarized in the statement that "constitutional" is the critically important one of the two words here. Economic prosperity and progress, as measured in value produced and consumed, can only occur in settings where the activities of government are constitutionally constrained, quite independently of how governmental agents are selected.

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Reputation and the Efficiency of Legal Rules

Louis De Alessi

Policy recommendations frequently are based on efficiency arguments that are unfounded or misleading. The application of economics to law offers some excellent examples: scholars repeatedly have failed to state the precise conditions (e.g., all consumers have identical preferences) that describe the world being analyzed, the empirical evidence (if any) that supports these conditions, and the value judgments (e.g., Pareto criteria) that provide the benchmark for the efficiency comparisons. The resulting policy recommendations are flawed and have occasioned a great deal of confusion and controversy.[1]

The discussions concerning the relative efficiency of alternative breach and product liability rules illustrate the issues. Some scholars have urged the adoption of strict product liability, arguing that it is more efficient than either *caveat emptor* or a rule of negligence because producers are better informed than their customers about product characteristics. If producers can form more accurate expectations regarding the probability of an accident and the harm that it causes, then strict product liability supposedly presents customers with prices that reflect more accurately the full costs of the products; as a result, resources are allocated more efficiently (e.g., Shavell 1980).[2] Similarly, other scholars have argued that, in some situations, breaching

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[1]For example, see the 285-page "Symposium on Efficiency as a Legal Concern" and its 161-page sequel, "A Response to the Efficiency Symposium," in the *Hofstra Law Review* (1980). In such debates, positive economics often is faulted for conclusions generated by normative judgments and questionable antecedent conditions.

[2]Among other flaws, this argument ignores that customers are better informed about their own individual circumstances, including how, when, and where they use a product.

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a contract may enhance efficiency. If circumstances change and transaction costs inhibit recontracting, then permitting a promisor to breach and pay damages instead of fulfilling the contract supposedly allows resources to flow to higher-valued uses (e.g., Polinsky 1983: 25–36).

In addition to other limitations (De Alessi 1992), these analyses neglect the role of trademark (reputational) capital in conveying information and assuring performance.[3] Trademarks offset, wholly or in part, the effects of positive transaction costs, including those arising from asymmetric information. Accordingly, policy recommendations supported by efficiency arguments that rest on the existence of costly information but ignore trademarks are flawed within their own frame of reference.

The present paper reviews the role of trademarks in providing information and assuring performance. It then examines the effect of trademarks on the arguments that a rule of strict product liability is more efficient than either *caveat emptor* or a rule of negligence and that, under some circumstances, it is efficient to breach a contract. To round out the analysis, the paper notes some of the value judgments implicit in many efficiency comparisons and offers a few concluding remarks.

Trademark Capital

Suppose that customers cannot establish the quality of a commodity before they purchase it. Then it seems that a firm has incentive to produce, and customers have incentive to buy, only the lowest quality viable (Akerlof 1970). But Benjamin Klein and Keith Leffler (1981) have shown that some firms engaging in repeat transactions can gain if they raise quality above this minimum, charge a price higher than salvageable costs of production, and invest the premium in reputational (trademark) capital. Trademarks allow customers, whether consumers or business firms, to form more accurate expectations about the quality of a product before they purchase it. If the sellers then fail to provide the quality promised, they forfeit at least some of their trademark capital. According to this analysis, trademarks assure quality.

Trademark capital, however, assures more than just quality. It assures *specific* performance, protecting customers from expectation losses in case of breach (De Alessi and Staaf 1994).[4] Although a customer who is harmed can always seek legal remedy, the suit may

[3]"Trademark" includes service marks and trade names. It is also described as reputation or goodwill.

[4]"Specific performance" is the performance of a contract according to the precise terms agreed upon. Legally, expectation losses include foregone gains from trade and reliance as

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not be successful or, if it is, the damages awarded may not provide full compensation (De Alessi and Staaf 1989). Damages are calculated by a judge, jury, or other outside observers who rely on market prices. Because market prices at best measure value only at the margin (cf. Buchanan 1969), damages typically underestimate actual losses. For example, damages exclude the gains that a customer forgoes on the inframarginal units. If damages are not fully compensatory and the courts do not enforce penalty and other clauses designed to yield specific performance, then promisees demand other assurances. Firms invest in trademark capital to establish a bond that provides these assurances by guaranteeing specific performance directly as well as by guaranteeing all other warranties and promises (e.g., money back if not satisfied).

Trademarks inform users. Customers' demand for trademarks is derived from their demand for information (and assurances) about product quality, warranties, post purchase service, and other performance characteristics. Producers' supply of trademarks provides that information (and assurances). Since Phillip Nelson's (1974) seminal paper, an extensive theoretical and empirical literature has supported the informational role of advertising and trademarks. Accordingly, efficiency arguments based on the assumption (antecedent condition) that users lack adequate information are fundamentally flawed unless they back that assumption with appropriate empirical evidence. Given the absence of any supporting evidence, it is useful to reappraise these efficiency arguments taking trademarks into account.

Efficient Product Liability Standards

The notion of efficient standards of liability in tort, where transactions in principle are involuntary, initially centered on the Learned Hand rule. According to this rule, a party is liable if the cost of taking precautions is less than the cost of the harm times the probability of the event.[5] John Brown (1973) noted the ambiguity of the rule and opened the way for a more rigorous analysis of the problem. More recently, Lewis Kornhauser (1986), Steven Shavell (1987), and others have pointed out that a truly efficient rule has to be particularized to each event. For example, an individual with a higher opportunity cost of time could drive faster without being found negligent in case of an accident than an individual with a lower opportunity cost of time.

Product liability typically arises from voluntary exchanges, say between producers of automobiles and their customers. If transaction

well as any reasonable expenditures. See Friedman (1981: 4–9) and Polinsky (1983: 25–30).

[5]Following Judge Learned Hand in *U.S. v. Carroll Towing Co.* (1947), let P be the probability of injury, L the gravity of the injury, and B the burden of adequate precautions. Then a defendant is negligent and liable for L only if $B < PL$.

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costs are negligible, the analysis pioneered by Ronald Coase (1960) implies that the legal rule of liability—neglecting wealth effects, whose size and direction are unpredictable—does not affect the final allocation of resources. Liability is allocated to the same least-cost avoiders by negotiating warranties under *caveat emptor* or disclaimers under strict liability. High transaction costs, as discussed below, inhibit these exchanges and raise additional issues, including some relating to the role of trademarks.

The standard analysis of product liability rules begins with the following assumptions (e.g., Shavell 1980; Polinsky 1983). Information and transaction costs are zero; sellers are wealth-maximizing price takers in both input and output markets; $c(x)$ is the U-shaped average production cost curve for commodity x; r is the probability of an accident to a customer; d is the loss per unit of output if the accident occurs; $m = rd$ is the expected damage per unit of output; $m' = r'd'$ reflects the values of r, d, and m perceived by the customer; insurance is fair and costs the same whether it is purchased by a producer or its customers, so that full cost $= c(x) + m$; the market price of the product includes the insurance premium for the liability incurred by the producer; all parties take the behavior of others as given; and all parties accept the rule of liability (they have no incentive to contract around it).

These assumptions yield the following implications. Producers choose the quantity of output that minimizes average production cost and, in equilibrium, marginal production cost is equal to average production cost. If all customers are identical and face the same expected damage m, then both customers and producers look at the same prices and Pareto efficiency conditions hold. Given that the true and the perceived expected damages are the same ($m = m'$) by assumption, the full price that customers pay is equal to the full price that they perceive and both are equal to full cost.

Under these conditions, the rule of liability merely determines the extent to which the producer acts as an intermediary in the insurance transaction. This conclusion follows because the full price that consumers pay is equal to the full price that they perceive at the time of purchase; both prices are independent of the rule of liability and are equal to full cost.

New possibilities arise if information costs are positive and differ between buyers and sellers. Continuing the standard analysis, suppose that producers have full information but that customers underestimate r, d, or both, so that $m' < m$. The full price *paid* by consumers, as in the previous example, is still equal to full cost.

The full price *perceived* by consumers, however, depends on the rule of liability. Under *caveat emptor* or a rule of negligence, the

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assumption that $m' < m$ implies that the full price perceived by customers is less than full cost. Accordingly, customers purchase "too" much x.

Under a rule of strict liability, producers must take into account the costs of all defects. Producers include the insurance premium m in the prices of their products and internalize the costs of all defects, regardless of who is negligent.[6] Because producers are said to be better informed than their customers, the market price p is equal to the full cost and customers do not underestimate the full price that they pay: $p = c(x) + m$. Producers and their customers look at the same prices, and Pareto optimality reigns: resources are allocated to their highest-valued use. Consequently, strict product liability is said to be more efficient than either *caveat emptor* or a rule of negligence.[7]

In a world of positive information costs, however, firms have incentive to provide product information and assurances by investing in trademark capital.[8] Thus, the market price of a product already includes a premium s that customers pay to obtain specific performance: $p = c(x) + s$.[9]

Because the premium associated with a trademark performs the same function as the premium associated with strict liability, *under the conditions assumed* the shift to a rule of strict product liability has effect only to the extent that m exceeds s. Trademarks offset the supposed lack of product information by customers. Thus, the existence of trademarks reduces, if it does not eliminate, the efficiency case for strict liability.

In practice, a shift to strict product liability can have substantial effects. For example, the rule may require a firm to provide more insurance than informed customers want to buy, encourage customers to engage in opportunistic behavior, and create greater uncertainty about the nature of the liability as different jurisdictions grope toward

[6]Under a rule of negligence, a firm is liable only if the court finds that it failed to exercise due care. Under a rule of strict liability, a firm may be liable even though it exercised due care.

[7]The shift to strict liability is akin to a Pigouvian tax and is open to all the criticisms that Coase (1960) levied at the latter.

[8]For present purposes, competition and monopolistic competition do not differ (Demsetz 1959, 1968).

[9]To provide specific performance, at the margin firms have incentive to take avoidance measures rather than insure. That is, firms have incentive to design and produce goods that are more likely to perform as promised and yield smaller expectation losses when they fail to do so, shielding buyers from damages even if the burden of adequate precautions is greater than the probability of loss times the value of the loss measured by a third party. Producers with trademark capital at risk have incentive to undertake avoidance expenditures greater than those predicted by the Learned Hand formula. Note that insurance, like damages, relies on measurements by third parties; thus, it is not fully compensatory.

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new standards. These costs occasion a premium u in addition to that required to provide specific performance. The market price of trademark goods and, therefore, the full price that customers perceive, may well exceed the "efficient" price.

Similarly, other conditions underlying the standard analysis do not hold. For example, the fact that consumers are not identical implies that—under strict product liability—those with expected losses greater (smaller) than the average premium pay "too" little ("too" much); Pareto efficiency conditions do not hold. More fundamentally, the assumption that producers systematically are better informed than their customers lacks empirical substance. Leaving trademarks aside, there is evidence that consumers are well informed about the products they buy.[10] Moreover, consumers typically purchase commodities from expert buyers, such as department stores, thereby reducing their demand for information about the characteristics of specific products. And even if producers are better informed about some product characteristics, their customers surely are better informed about how, when, and where they are going to use the products. Efficiency comparisons based on asymmetric product information are even weaker when the producers have trademark capital at risk and when the customers are other firms, which frequently have substantial wealth at stake and are well motivated to acquire and use information. One could argue just as cogently that *caveat emptor* is more efficient than strict product liability because customers are better informed than producers.

According to the efficiency rationale used to compare liability rules, under a regime of strict product liability the full prices of trademark products may actually be too high, discouraging consumption. Thus, too few rather than too many resources are devoted to these products.

Event studies by Sam Peltzman (1981) and others (see summary in De Alessi and Staaf 1994) indicate that deceptive advertising, product recalls, and fraud result in a substantial loss of trademark capital. This empirical evidence buttresses the quality assurance/specific performance hypotheses (De Alessi and Staaf 1994). Because the wealth losses observed are a multiple of any possible direct costs involved, the price premium that assures performance appears to exceed by a substantial amount the price premium associated with a shift to strict liability. Accordingly, the efficiency argument for strict liability is greatly weakened in the case of trademark goods: Producers of these

[10]For example, consumers have not used the Federal Trade Commission's "Cooling-Off" Rule, which was intended to protect them from door-to-door salesmen (McChesney 1984). Similarly, consumers' behavior under the FTC's Funeral Rule suggests that they are well informed (McChesney 1990).

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goods already undertake additional avoidance measures to protect their trademark capital, reducing the residual risk, if any, that would be insured against under strict liability.

At least in the case of trademark commodities, the case for strict product liability is flawed. This conclusion does not imply that *caveat emptor* or a rule of negligence is preferable. The answer depends on the value judgments used for the comparison.

Efficient Breach

Suppose that the courts require a promisor to provide specific performance even though circumstances have changed. Perhaps a lower-cost alternative has become available, the cost of performance to the promisor has increased, or the value of performance to the promisee has decreased. Then, it is argued, too many resources are allocated to fulfilling the contract and efficiency considerations indicate that the promisor be allowed to breach and pay damages.

This conclusion rests on several assumptions that are unwarranted. For example, an outside observer must be able to identify and measure values, the law must be particularized to each event, the redistribution of wealth must not matter, and transaction costs must be prohibitive—if they are not, the Coase theorem implies that the parties renegotiate and resources flow to their highest-valued use (De Alessi and Staaf 1989, De Alessi 1992). Moreover, trademarks do not exist.

The case for an efficient breach focuses on a particular contract as an isolated event and ignores the trademark capital of the parties involved. If damages are not compensatory, if the promisor breaches more frequently than the promisee had anticipated, and if other actual and potential promisees know about these events, then the promisor can negotiate future contracts only at a lower price; its trademark capital falls. Specific capital is equivalent to a legal penalty clause that assures specific performance. Like all self-enforcing contracts, it helps solve the problem of high transaction costs.

Instead of investing in trademark capital, a seller could simply offer to pay some multiple of the damages assessed by a third party. Some promisees, however, would behave opportunistically and seek to induce a breach; this possibility has been used to explain why penalty clauses are not enforced (Clarkson, et al. 1978).[11] One alternative is to pay damages to a third party. Although such contracts are difficult to draw, Charles Knoeber (1983) has shown that they exist. Trademark capital enjoys a similar advantage. Because the loss in trademark

[11]For a different view, see Goetz and Scott (1977).

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capital does not accrue to those supposedly harmed by the breach, it does not encourage them to spend resources on opportunistic (breach-inducing) behavior.

Strictly interpreted, criteria for evaluating the efficiency of legal rules require an array of standards that, in the limit, equal the number of transactions. Competing firms who provide a broad spectrum of trademark capital assure a wide range of quality and performance tailored to individual circumstances. Trademark capital represents a response not only to the inability of third-party observers to calculate fully compensatory damages and the reluctance of the courts to enforce contracts, but to the inability of the legal system to particularize rules to individual circumstances. Common law doctrines in tort and contract are "common" principles that permit little variation (De Alessi and Staaf 1991). Differences in trademarks provide variations in assurances and allow a broader array of standards.

Once again, the analysis merely indicates that the argument for efficient breach is flawed. It does not indicate which rule is preferable.

Some Value Judgments Implicit in Efficiency Comparisons

To demonstrate the relative efficiency of alternative legal rules, economists frequently make assumptions about values and states of the world that are debatable or unwarranted (De Alessi 1990, 1992). Some of these assumptions are implicit, and analysts may not even realize that they are making them. Other assumptions, even if explicit, are so frequently and widely used (e.g., Pareto criteria) that they have become commonplace and their significance is overlooked. As a result, conclusions that are strictly subjective are cloaked with the appearance of objectivity.

Many studies assume, often implicitly, that all individuals have identical preferences and even identical endowments. These assumptions lack any empirical bases and yield implications that are inapplicable to the real world. For example, contractual and institutional arrangements formed precisely because people are different—and this is true for most, if not all, contracts—would be inefficient. The assumptions of identical preferences and endowments also mask some strong value judgments. In the case of strict liability, some customers are more likely than others to have an accident or to incur larger losses if an accident occurs. As a result, customers whose expected losses are above the average premium included in the market price gain wealth at the expense of those whose expected losses are below

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the premium.[12] In the case of an "efficient" breach, the party breaching typically gains wealth at the expense of the promisee, who receives damages instead of specific performance. The assumption that individuals are identical helps to mask the value judgment that the wealth redistribution associated with different rules does not matter.

Most efficiency comparisons also contain the implicit assumption that an outside observer can estimate true values using market data. As James Buchanan (1969), Armen Alchian (1968), and others have emphasized, market prices at best measure value at the margin. They do not reveal the value that the chooser attaches to the inframarginal units acquired and to those foregone. As a result, an outside observer typically underestimates the full costs at issue; damages are not fully compensatory (De Alessi and Staaf 1989).

The efficient breach argument also contains the implicit assumption that a promisor is entitled to breach by paying damages (the price). But even ignoring moral considerations (e.g., "Is it acceptable to commit a crime if the perpetrator is willing and able to pay the price if caught?") and supposing that damages are fully compensatory (i.e., all gains from trade and reliance as well as all relevant costs are included), the party who breaches is able to capture all gains from the subsequent trade (Friedmann 1989). Thus, damages and specific performance entail different distributions of wealth; they are not perfect substitutes.

Finally, the choice of Pareto efficiency criteria as a benchmark is purely arbitrary. The value judgments underlying Pareto criteria need not be universally accepted and the compensations necessary to fulfill Pareto efficiency conditions certainly cannot be implemented (De Alessi 1992).

Conclusion

The efficiency arguments used to establish the superiority of a rule of strict liability over rules of *caveat emptor* and negligence and to justify the breach of some contracts do not hold even within their own frame of reference. Strict liability is said to be superior because the resulting price premium compensates for customers' tendency to underestimate the cost of a product's defects. But the price premium that customers pay for trademark goods to obtain assurance of specific performance already performs that function. This and other considerations discussed in the paper suggest that strict liability may result in

[12]Customers whose expected losses are greater (less) than the average premium would use "too" little ("too" much) of the product.

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a price that is "too" high rather than "too" low, negating the rule's efficiency claims. Similarly, some contractual breaches are said to be efficient because, in the presence of substantial transaction costs, they facilitate the flow of resources to their highest-valued uses. In addition to other flaws, this conclusion ignores the role of trademarks. Trademarks, like other self-enforcing contracts, help solve the problem posed by high transaction costs. They also inhibit opportunistic breaches, substituting for the inability of third-party observers to calculate damages that are fully compensatory, the reluctance of the courts to enforce contractual provisions (for example, penalty clauses and specific performance) that discourage breaches, and the inability of the legal system to particularize rules to individual circumstances.

More generally, efficiency comparisons typically rest on conditions that are empirically unfounded and value judgments that are unjustified. Economic theory simply does not provide an answer to the question: Which rule is preferable? Policy recommendations based on efficiency considerations are inherently suspect. Indeed, as Buchanan (1960: 87–88) noted, "By the very nature of free markets, . . . the only entity required to compare two social alternatives when a choice is actually made is the individual. . . . It [the market] will choose what the market will choose."

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The Assault on the First Amendment: Public Choice and Political Correctness

Paul H. Rubin

It is possible to radically change the meaning of the Constitution without changing one word of the document. This has happened, for example, with respect to the Takings Clause of the Fifth Amendment (Epstein 1985, Rowley 1992) and the Contracts Clause. The words in both of these clauses remain unchanged in the Constitution, but both have greatly reduced force today relative to, say, the pre-New Deal world. Moreover, the Supreme Court in recent years has established interpretations of the Constitution that agree with the mainstream of American constitutional jurisprudence (Farber and Frickey 1991: chap. 3; Horwitz 1992). As a result, most constitutional scholars do not point out that the Constitution has been radically reinterpreted.[1]

The courts have already substantially reinterpreted the Constitution to reduce protection of economic liberties. Thus, scholars interested in constitutional protection of freedom must act as historians, and must attempt to determine what forces caused existing constitutional changes. Although there are sudden changes in constitutional jurisprudence (e.g., the 1937 "Switch in Time"), the detailed working out of the implications of these reinterpretations takes some time. This is

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[1]Daniel Farber and Phillip Frickey write from a public choice perspective, but essentially reject most of the normative conclusions of most public choice scholars. Their discussion of *Lochner* is instructive. They indicate that the Supreme Court in *Lochner* "considered maximum hours legislation to be a violation of the rights of bakers and their employees" (Farber and Frickey 1991: 67). They do not argue with this view, which is of course correct on its face. Rather, they argue against what they claim to be the public choice defense of *Lochner*, that "it protects freedom of contract for instrumental reasons, not because it views this freedom as an intrinsically important value" (1991: 68). By this rhetorical twist, Farber and Frickey are able to avoid discussing the merits of contractual freedom.

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because even constitutional jurisprudence takes place in a common law framework so that numerous decisions are needed to clarify the implications of changes in interpretation. For example, even now the implications of the failure to enforce contracts in the context of product liability are still being developed (Rubin 1993).

Today we are in the midst of another major change in the Constitution. Substantial classes of protection of free speech under the First Amendment are being seriously attacked.[2] This attack is worth studying for two reasons, one positive and one normative. As scholars we may observe the process of constitutional revision, so as to better understand the driving forces behind this change. It is particularly interesting to study which processes are succeeding, and which are not, meaning that some comparative analysis is required. However as contemporaries, scholars with unpopular (or politically incorrect[3]) views will want to give a normative assessment of the specific changes that they observe as well.

In the next section, I shall identify some of the players in the interest group battle over academic freedom, followed by a section that offers an interest-group-based theory of the attack on the First Amendment. I then describe the process leading to censorship of speech in the workplace. This is interesting because it demonstrates a mechanism by which an explicit constitutional restriction ("Congress shall make no law. . . abridging the freedom of speech") has been weakened.

The Challenge to Academic Freedom

Several authorities have documented the movement towards political correctness on university campuses (e.g., D'Souza 1991; Schlesinger 1992; Rauch 1993).[4] This challenge to free speech has received the most attention, but it has been the least successful. For example, in two cases the Supreme Court has overturned speech codes in public universities. Indeed, the forces that have caused political correctness to receive so much attention have been the same forces that have caused its relative lack of success.

Attacks on free speech in universities aim at the economic interests of academics, and it is not surprising that academics have responded

[2]This paper does not deal with protection of "commercial speech," which has already been greatly restricted. (See, e.g., McChesney 1988; Rubin 1991.)

[3]I will use the term "politically correct" to include the entire corpus of current intellectual fashions, including speech codes and such concepts as multiculturism.

[4]Jonathan Rauch's is a particularly useful work, as it presents a basically economic theory of the growth of knowledge. The author demonstrates the detrimental impact of political correctness on the expansion of human knowledge.

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with a vigorous effort to defend these rights. This effort has included the standard interest group techniques. An organization, the National Association of Scholars, has been formed. There are also litigating organizations, such as the Center for Individual Rights in Washington, and there has been litigation leading to the overturning of two state laws restricting speech on public campuses. When the Middle States Association of Colleges and Schools challenged some universities for lack of "diversity," lobbyists were able to persuade the Department of Education in the Bush administration to change this policy.[5] Academics and their allies have given widespread publicity to these efforts, thereby depriving them of the secrecy and obfuscation that are useful to interest groups in pursuing their goals (Magee, Brock, and Young 1989).

Yet, universities have themselves tried to limit free speech of students. A policy that protects academic freedom for professors but limits protection granted to other speech on campuses can be observed in some cases (Lange 1990). Student interest in their own speech is primarily a consumption interest, and does not alter earnings. Moreover, students are in a particularly vulnerable position as an interest group: no student remains at a university for more than a few years, so that long-term investment in rule change is not worthwhile. Thus, it is not surprising, that when protection is given to student speech, this is mainly a byproduct of protection obtained by faculty.

Interest Groups and the First Amendment

Who are the players in the free speech game? Opponents of free speech are, among others, those professors and other intellectuals who are in favor of political correctness, and the civil rights establishment, including representatives of both blacks and women. Defenders of free speech include those professors whose views would be censored if political correctness became mandated in universities, and their allies in the media.

The attack by some professors on the speech rights of others is a puzzle. Since academics make their livings through debate, it would appear that their interests would be in relatively free discussion. Moreover, a debater becomes more valuable when he has an opponent. Thus, there appears to be an economic interest among academics in unregulated speech, a notion that has received support in economic theory and public choice theory of the First Amendment in particular.

[5]The outcome was discussed in the *Wall Street Journal* (1992). If the current (Clinton) administration gets going full blast, such an attack may be renewed.

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Thus, the current popularity of political correctness on campuses is an enigma.

Jonathan Macey (1992) argues that politicians have an interest in free political speech because this increases their incomes through formation of additional interest groups which would lead to increased political donations. Richard Posner (1992: 621) suggests that the First Amendment is a "form of protective legislation on behalf of an interest group consisting of intellectuals, publishers, journalists, pamphleteers, and others who derive pecuniary and nonpecuniary income from publication and advocacy" (see also Posner 1987: 7). Fred McChesney (1988) indicates that the number of intellectuals who would profit from regulation is always smaller than the number of those who would lose, so that intellectuals would always oppose regulation of speech. Ronald Coase (1974: 390) writes that demand for the product of intellectuals is increased if there is open competition between differing schools: "the public is commonly more interested in the struggle between truth and falsehood than it is in the truth itself." Albert Breton and Ronald Wintrobe (1992) concede that some academics may have an incentive to overprotect the paradigm in which they work, but they also point out that this control is mainly exercised through the refereeing and tenuring processes, and that outside boards and granting agencies provide a check on such incentives. Moreover, they claim that the self interest of academics naturally limits such tendencies anyway.

Given this view, what is puzzling is that one branch of the current attack on the First Amendment and on free speech is being led by a subset of the academic and intellectual coalition and that the limits to free speech that are sought go well beyond what Breton and Wintrobe mention in their discussion. There is a group of professors who are themselves major players in the campaign to limit production of ideas—an anomaly in interest group theory. Moreover, the liberal professoriate has a set of allies in the attack on free speech. The civil rights establishment, including members of the women's movement, is also associated with attempts toward reducing free speech. In discussing these various interests and their interactions I shall adopt a public choice perspective.

Civil Rights Leaders

The brute fact with which we must begin is that legal prohibitions of race and sex discrimination have not led to equal outcomes in the workplace. Even though discrimination is illegal and is vigorously attacked by both private plaintiffs and government agencies, women and members of some minority groups still earn less on average than

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white males, and hold lower level jobs. Our analysis begins with this economic fact.

The dominant view is that these persistent differences must be due to some residual discrimination that the civil rights laws have been unable to root out. This assessment is the basis for the Civil Rights Act of 1991, which institutionalizes through statute the notion of "disparate impact" in employment practices. Disparate impact (as e.g., analyzed by Richard Epstein 1992) is said to occur when some employment practice leads to differences in outcomes by race or sex and the employer cannot prove that the differences are "bona fide occupational qualifications."[6] If the notion that all occupational differences are due to discrimination is wrong (as has often been persuasively argued by Thomas Sowell, e.g., in 1994), then the entire corpus of modern civil rights law as applied to occupational differences is wrong. These are the economic stakes in the intellectual debate.

Academics

The liberal academic world view in the humanities has two basic pillars. One is a form of Marxism and the other is the notion that most or all differences between humans are due to environmental factors; genetic elements can have no influence. Neither of these positions is intellectually tenable. However, an entire generation of academics has much of their human capital invested in these ideas, so that if they were rejected this human capital would become much less valuable.

Such a reduction in the value of human capital is not uncommon; according to Thomas Kuhn (1970), this would occur whenever there is a major paradigm shift within a science. The position of liberal humanists may be worse than that of academics facing a normal paradigm shift because the challenge is so fundamental. Most paradigm shifts leave some room for some time for practitioners of the outmoded paradigm; they may, for example, be able to teach undergraduates and preserve some of their human capital. Indeed, in some cases the new paradigm will even leave the existing paradigm unchanged in some areas: Keynesian economics did not eliminate classical price theory, and Einsteinian physics did not replace Newtonian mechanics for many physical analyses. Thus, liberal humanists may have a stronger incentive than most academics to defend their

[6]In a given case, the issue generally comes down to burden of proof. It is difficult to prove that some practice such as an ability test is a bona fide occupational qualification, so that if the burden is on the employer many tests will not be used, even though in fact test performance is related to job performance.

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paradigms because the replacement would be more fundamental than has been true for other disciplines.

It is also possible that the defense is worth making because these scholars have supporters outside the academy, thus making success more likely. As will be seen below, both pillars of the liberal academic world, the Marxist world view and the environmental causation theory, are necessary for defending current civil rights laws. Therefore the civil rights establishment has sided with a certain segment of the academic community; indeed, in some cases activist academics are also leaders of community groups outside adademia. Thus, the academic defense of failed paradigms gets added strength from outside sources and may be more spirited than is usually the case. Breton and Wintrobe (1992) observed in a similar vein that as the outside market for academic and scientific ideas becomes larger, the incentive for self regulation of scientific ideas becomes smaller.

Marxism as the First Pillar of Liberal Humanism. Marxist theory is based on the notion of group or class interests. In classic Marxism, employers or capitalists collude and exploit workers. In today's version, men and whites collude to exploit women and blacks. The key assumption is that members of a class act in concert to advance class interests. This perception differs from the mainstream economic view that individuals act to advance their interests as individuals, which often conflict with their putative interests as members of a class.

Collusion by employers to act as racists or sexists would take the form of an implicit agreement to pay members of the exploited class less than they were worth. But any employer who "cheated" and hired women or blacks without discriminating could make a lot of money because he could get workers at a bargain wage. Employers seeking this money would bid up the wage of the exploited class and thereby eliminate any remaining racism or sexism. Marxist theory would suggest that such collusion would be possible. Mainstream economics indicates that this behavior is inconsistent with normal self-interested maximizing behavior.

Jim Crow laws or illegal terrorist groups such as the Klan can enforce racist policies, but absent these forces, any residual occupational differences cannot be due to discrimination by employers. Differences in earnings must be due to differences in productivity. Discrimination by customers or other employees could cause some of this productivity difference (Becker 1971). Customers might be unwilling to deal with minority employees, or employees might demand a premium to work with members of minority groups. If such preferences exist, capitalists would accede to them. However, capitalists would neither cause nor profit from this discrimination and so could

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not be blamed for it in any moral sense. Indeed, capitalists would prefer that discrimination not exist because profits, at least in the short run, would be increased if constraints on hiring minority workers were relaxed.

In a way, it is odd that academic Marxism has survived so long among scholars in the humanities. Marx was an economist. Economists (except for a few idiosyncratic "radical political economists") have rejected his views for many years. The survival of Marxism and its sundry French structuralist variants in the humanities is as intellectually respectable as would be a theory of literary or historical criticism based on other outmoded scientific ideas, such as astrology or phrenology.

Although Marx survived for a while the intellectual attack from economists, the game is now over. No one today observing the world can seriously consider Marxist ideas to have any intellectual respectability. Marxism has been the subject of the most decisive experiment ever performed in the social sciences, and this experiment has culminated with the fall of the Russian empire. Breton and Wintrobe (1992) argue that where direct experimental testing of an idea is possible, competition between ideas will eliminate those ideas with little truth value. Defenders of Marxist ideas, or of methods of literary or historical scholarship based on these ideas, can only survive by outlawing any intellectual challenge to their beliefs. This is what the notion of "political correctness" attempts to do. As it happens the Marxist concept of class interest provides a useful underpinning of the "politically correct" notion that occupational differences between men and women or between blacks and whites are due entirely to discrimination, thus forging an alliance between advocates of the current civil rights culture and academic leftists.

Environmental Determinism as the Second Pillar of Liberal Humanism. The belief that all differences between individuals are due to their environment is the second pillar of liberal scholarship. This belief is particularly important for feminists. If there were economically relevant innate differences between men and women, then differences in earnings could be due to factors other than discrimination or differential socialization. For example, if there were innate differences between the desire and ability of men and women to spend time raising children, then women's reduced earnings caused by reduced time in the labor force is neither discriminatory nor due to socialization.

The view that there are no innate differences between human beings has been intellectually untenable since at least 1975, when Edward Wilson published his monumental *Sociobiology*. Indeed, it was never based on any scientific evidence (see Degler 1991). While

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humanists and feminists have been advocating ideas based on no innate differences, psychologists, and other behaviorally based social scientists have been pursuing research agendae exploring the evolutionary nature of human behavior.[7] While sociobiologists have not examined or theorized much on differences between races (perhaps in part because of the hostility with which such research would be greeted), there is no intellectually respectable case that can be made for the idea that behavioral differences between men and women are due solely to socialization processes or cultural influences. This idea of course illustrates the intellectual poverty of much contemporary feminist scholarship. It is also inconsistent with the view that all occupational differences between men and women are due to discrimination.

Politically liberal academics have understood this challenge. Wilson's ideas and even Wilson himself have been subject of vicious assaults. Marxist biologists have attacked biological theories of human behavior (Lewontin, Rose, and Kamin 1984). Some have even claimed that human language ability arose from non-Darwinian forces, as discussed by Steven Pinker and Paul Bloom (1992).[8] Indeed, there is a widespread attack by the left on science in general (Gross and Levitt 1994). However, despite these attacks, working scientists proceed with their research under the evolutionary paradigm. For political reasons, however, scientists do not attempt to derive the implications of this research for the humanities. Most humanists simply ignore the science.

An analogy to the IQ debate may be instructive. Mark Snyderman and Stanley Rothman (1988) have compared views of "experts" (primarily academic psychologists) with the mainstream views of the media on issues relating to IQ. They find that experts' views are significantly different from the views discussed in the media, which are mainly the standard views of the liberal establishment. Experts continue doing their research, but at the same time seem to try not to become involved in public controversies.

As an aside, we should note that as long as there are racial differences in performance on tests and these tests are correlated with performance on the job, disparate impact will be inefficient, no matter

[7]An excellent recent collection of papers discussing this view by psychologists, anthropologists, and biologists was published by Jerome Barkow, Lida Cosmides, and John Tooby in 1992.

[8]It is interesting that Noam Chomsky, one of the most virulent critics of modern American society, as a scientist provided the basis for one of the major attacks on the liberal world view. Chomsky showed that there is a biological basis for language acquisition. Pinker and Bloom (1992) discuss his efforts to show that this biological basis was not evolutionary. Of course, this effort is doomed.

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what the source (heredity or environment) of these performance differences. Claims that differences are environmental rather than genetic are red herrings, since the source of the differences is irrelevant to an employer. Even if the tests are "culturally biased," differences will still be related to productivity since job performance is also culturally determined. As Snyderman and Rothman (1988: 108–10) point out, a test may accurately measure differences in intelligence between groups where the differences are not due to heredity, but the test may still be accurate in that its predictions (regarding success in school or on the job) may be useful.[9] Indeed, to the extent that differences in IQ tests are environmental or cultural rather than genetic, "multicultural" education will increase earnings deficits of minority groups since it will exacerbate such cultural differences.

The Coalition

Consider these points: the world view of liberal academics, especially in the humanities, is that all occupational differences are due to discrimination rather than to any innate differences among individuals. This view is being challenged by standard non-Marxist neoclassical economics and modern biological theories of behavior. If there were a free battle of ideas today, these empirically well-founded and theoretically sound theories would win and the misconceived intellectual underpinnings of civil rights law would be shown to be crumbling. In a democracy, it is difficult or impossible in the long run to implement policies that lack any intellectual justification.[10] If the basis for the scholarly work of academic humanists is admitted to be faulty, then their incomes could be expected to fall. If the intellectual basis for current civil rights policies were shown to be flawed, these policies would be more difficult to implement. Therefore, academic liberals and their allies prefer to avoid a free debate because they have too much to lose. There is common cause between these two groups, based on mutual self-interest.

[9]This paper was completed before the publication of *The Bell Curve* (Herrnstein and Murray 1994). However, much of that book is obviously relevant to the arguments made here. Two points in particular are worth noting. First, Herrnstein and Murray document the effect of race on IQ and the effect of IQ on labor market productivity, lending support to my argument that racial differences in earnings are due to productivity differences rather than discrimination. Second, the vicious anti-intellectual hostility with which the book has been received by the liberal establishment is quite consistent with the arguments made here regarding the incentive of those who are wrong to suppress arguments which are counter to their positions.

[10]This does not say that the justification need be correct, or even logical, only that it exist. Supporters of tariffs are forced to make arguments based on "fair trade"; they are not able to rely on naked self-interest to justify their preferred policies.

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I am not claiming any deep conspiracy on the part of participants. Each actor is acting in his or her interest and probably even following his or her own sincere beliefs. It is simply that the interests and beliefs of many independent agents coincide, and so these agents form implicit alliances to advance a particular agenda. The agenda may be extremely harmful, but the motives of its advocates need not be particularly sinister.

The greatest threat to this coalition is free speech, as protected by academic freedom and by the First Amendment. In some cases, the First Amendment has so far held. Thus, the Supreme Court has overturned speech codes at some state universities because these codes violate the First Amendment. However, private universities have less protection, and many have adopted speech codes that would clearly violate the First Amendment if adopted by public institutions. While these codes often claim to offer protection to academic freedom, the line is thin and many academics are intimidated by the nature of the intellectual environment at many universities.

By labeling any persons who disagree with them as racist or sexist, defenders of the current liberal paradigm are able to protect it. Disagreement is not only viewed as a sign of intellectual dissension; it is characterized as an indicator of low moral value. Because of the theoretical weakness of the paradigm this argument carries particular weight. Ambitious scholars would attack the paradigm if it were not protected by morality.[11] The effort to convert intellectual disputes into moral disputes may be a more general method of attack; McCarthyism proceeded by accusing those with certain sets of beliefs as being not only misguided, but also as being traitors.

Workplace Speech

If the hypothesis above is correct, then there should be other challenges to free speech in addition to challenges in the academic environment. Indeed, there are. Free speech has also been attacked in non-academic workplaces. This challenge to free speech has been much less documented but has been more successful (Browne 1991). Essentially, government has eliminated most free speech protection in the workplace. From a public choice perspective, it is not surprising that professors have done better than other workers in defending their rights to speech. To academics, speech is an economic good; it is how we make our living. To other workers, speech of the sort

[11]For Example, Camille Paglia (1992) became famous for one attack on current wisdom.

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involved in the debate (for example, the right to pinups in a locker or to tell "dirty" jokes at work) is a consumption good. Even policy statements ("Women belong at home and should not work here") are statements with consumption, not instrumental, value for non-intellectual workers. Public choice tells us that defenders of economic rights would often be expected to do better in the political arena than would defenders of consumption rights. Moreover, it is likely that professors place more value even on the consumption aspects of speech than do other workers, since there is self-selection into academia based in part on this value.

The process by which free speech in the general workplace has been limited is interesting because it demonstrates techniques used to successfully subvert what appears to be a clear constitutional right. While protection of academic speech has more or less persisted, the case of workplace speech for non-academics is very different. Here, there has been a total elimination of first amendment rights with respect to speech that the courts will call racist or sexist. The civil rights establishment has led the attack, for essentially the reasons addressed above. If there are indeed racial or sexual differences in productivity and if workers would be allowed to freely point out these differences, then the rationale of current civil rights laws would of course be suspect. Thus, there are clearly economic reasons behind the challenge to workplace speech.

There is an odd twist in the law that has been used to weaken the First Amendment. The Civil Rights Act of 1964 does not mention speech or harassment, so that Congress did not directly pass a law violating the Amendment. Of course, the First Amendment does not apply to private employers. A private employer could unilaterally adopt a speech code that would violate the First Amendment if a government body adopted it, and private employers routinely do so for all sorts of reasons. No one would blame an employer for firing an employee who suggested that goods produced by the employer were shoddy, for example.[12]

The Equal Employment Opportunity Commission (EEOC) can indicate what rules it believes should govern. A private employer can then adopt these rules to avoid entanglement with the EEOC. The

[12]This section is based on Kingsley Browne (1991), who deplores the changes he describes. This view appears to be in the minority among legal scholars. For example, Lange (1990) suggests that campus speech can be censored using an analysis similar to that used for workplace speech. J.M. Balkin (1990) notes that the same arguments can now be used to weaken the First Amendment that were previously used to weaken freedom of contract; Balkin agrees with both of these policies. I would like to thank Charles Shanor for pointing out these references to me.

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result is that EEOC, a creature of Congress (and thus supposedly covered by the First Amendment) can implicitly coerce employers to censor the speech of employees. Unless an employer is willing to litigate on behalf of an employee who engages in forbidden speech, the issue will not be litigated, and the First Amendment will not offer protection. An employee disciplined for speech violations is being punished by his employer, and has no standing to sue the EEOC.

Most people would find the sort of language banned by workplace speech codes personally obnoxious. Employers would have little to gain by litigating for the right of a worker to engage in racist or sexist speech, or to put pinups in his locker. Employers who are liable for employees' improper speech are likely to take a very expansionist view of what speech is prohibited since they have little to gain by allowing prohibited speech and have large potential liability. Thus, the actual practice of censorship may go beyond even that which the courts would sustain.

The finesse is that Congress did not pass any law that directly regulated speech. The Civil Rights Act does not mention any sort of harassment. Nonetheless, the courts and the EEOC have defined harassment to be a form of discrimination. Originally, this applied to *quid pro quo* harassment—demanding of sexual favors in return for job-related benefits, such as hiring or promotion. But the law has been expanded to include a "hostile environment" as a form of harassment. A hostile environment as defined by EEOC-guidelines includes offensive "verbal or physical conduct"; verbal conduct is interpreted by the courts as meaning speech. If an employer were to put out an internal company newsletter saying, "We believe that women are not suited to perform certain types of jobs, but we must hire them because of the law", this speech would likely be found to indicate a hostile environment and be a form of harassment. If a fellow employee announced the same beliefs on the job, this would also create a hostile environment.

The issue of a hostile environment is seldom if ever litigated. Indeed, as of 1990, no Title VII claim asserted a First Amendment defense (Lange: 120, n. 93) even though such cases have been litigated since about 1971 (Lange: 122). Moreover, the courts have from time to time indicated that the First Amendment would not govern in such cases (discussed in Browne: 482). Although in most cases there were actions in addition to speech used to find a hostile environment, in a 1991 case the entire matter rested solely on speech issues (posters, calendars, and jokes); there was no claim of physical assault or sexual propositions (discussed in Browne: 495). Thus, apparently courts are beginning to find speech more actionable.

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Conclusion

The story told here is a standard interest-group story. Scholars in the humanities have an interest in preventing certain types of speech because many of their ideas are easily shown to be wrong and their incomes and positions would suffer if this demonstration were allowed to be made. They have formed an implicit alliance with members of the civil rights establishment because many of the ideas of the academics are also the basis for important civil rights doctrines, such as the use of "disparate impact" standards for finding discrimination. Academics with an interest in "politically incorrect" speech have mostly been able to defend their position (so far) but others with no economic interest in such speech (students, workers in non-academic workplaces) have not.

Believers in constitutionalism sometimes act as if a constitutional prohibition will itself offer substantial protection. However in the case of the First Amendment, this is not so. Recent initiatives by academics and by the civil rights and feminist hierarchies to limit speech in the workplace have been successful, and for all practical purposes an entire class of speech has been denied protection. Constitutional protections have held up only where an economically interested group has spent real resources defending these protections.

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Social Security: Rates of Return and the Fairness of Benefits

Philip J. Harmelink and Janet Furman Speyrer

Considerable publicity has been given in recent years to issues relating to the fairness of the social security system. Examples of such issues include the relative burden of the social security tax (employee and employer contributions) and the self-employment tax (Musgrave and Musgrave 1989, Harmelink and Speyrer 1990) and the distributional burden of taxes on social security benefits (Pellechio and Goodfellow 1983, Sammartino and Kasten 1985, and Harmelink and Speyrer 1992). Another aspect of the social security system that has received the attention of academicians and other policymakers is the fairness of the benefits structure. Specifically, inequalities in benefits can occur between single individuals of different sexes and between households with different incomes, ages, spousal income splits, and marital statuses (Outslay and Wheeler 1982; Boskin, et al. 1987; and Feldstein and Samwick 1992).

Edmund Outslay and James Wheeler (1982) quantified the payoff from social security contributions and identified various inequities in the benefits structure. They compared the benefits that would be payable under an annuity plan for workers of varying wage levels, family compositions, and working periods, with the benefits the same workers would have been entitled to under the social security benefits structure. Their results showed that future retirees could expect to receive sizable transfer payments in almost all cases, but that the difference in the dollar amounts between single-earner and two-earner families would increase in the future.

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Michael Boskin, et al. (1987) computed the expected present value of social security benefits and taxes for households with different characteristics and earnings levels. In addition, their analysis incorporated the internal rate of return for the retirement portion of social security contributions. They found real internal rates of return on social security contributions ranging from negative numbers to 6.3 percent. They noted the inequities between single men and women, between married couples and single individuals, and between married couples with different earnings splits.

Martin Feldstein and Andrew Samwick (1992) approached the topic from a different standpoint by examining the net marginal social security tax contribution rate. In calculating the appropriate tax rate, they adjusted for differences in the income, age, sex, and marital status of workers. Estimation of the present actuarial value of benefits received and the prediction of the tax rate for income received after retirement are key elements in this calculation. They concluded that the rates differ significantly in ways that reduce the equity and efficiency of the social security program. They found that the net marginal rates are very low or even negative for some employees but that the full statutory 11.2 percentage rate (employee and employer contributions of 5.6 percent each for old age and survivor benefits) applies to young workers, to workers who qualify for social security benefits as dependent spouses, and to the very poor.

Policymakers have conducted related studies highlighting these social security equity issues relating to gender, marital status, age, and income. For example, the *Report of the HEW Task Force on the Treatment of Women Under Social Security* (HEW 1978) and the congressional *Report on Earnings Sharing Implementation Study* (1985) outlined several equity concerns and numerous approaches, including earnings sharing schemes, for allegedly alleviating the inequities. Other related studies include, for example, those by the Social Security Administration (1985), and a study by Iams and Ycas (1988).

The present study determines internal rates of return for the retirement portion of the social security contributions for hypothetical individuals and couples with varying earnings splits and a range of ages and income levels. We compare pre-tax rates of return on social security contributions to those of alternative investments for similar time periods. Further, we examine the after-tax rate of return on the contributions for these hypothetical individuals and couples to determine the extent of the various inequities. In both of these analyses, we circumvent the difficult issue of choosing the appropriate discount rate to use in the present value calculation.

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In addition, we explore earnings sharing as an alternative to the current benefits structure of the social security system. As evidence of the importance of this work, Feldstein and Samwick (1992: 18) suggested that more equitable treatment of married couples "could be achieved by pooling the couple's social security earnings and taxes and dividing them equally between both members" and recommended additional research in this area as a basis for reform. We also discuss other possible changes in the benefits structure to address the important topic of fairness.

Equity Issues

Issues concerning the equity of the social security system arise as a result of differences in marital status, gender, age, and income. Changes in demographic and economic situations in this country in recent years make it imperative that these equity concerns be assessed.

Marital Status Inequities

Many factors verify that the decline of the "traditional" family has occurred. According to the U.S. Decennial Census, the labor-force participation rate for women has risen to 56.8 percent in 1990 from 37.8 percent in 1960. The number of women under age 65 in the work force has nearly doubled since 1970. The number of families with both wife and husband working has increased 73 percent since 1970. This fact suggests that, even where children are present, the work force participation rate of women is high. Also noteworthy are the facts that the number of one-parent families has increased 150 percent in the past 20 years, the number of persons living alone has more than doubled since 1970, and the number of unmarried couples is more than six times as great as in 1970.

Under the present system, complaints relative to marital status arise from the fact that benefits for a one-earner couple consist of a worker's benefit and a benefit for the homemaker spouse equal to one-half of the worker's benefit. These married single-earners have not paid additional social security contributions for the right to receive the homemaker's benefit. Contributors to the social security system who have worked outside the home maintain that they are not reaping the advantages (in the form of social security benefits) from having worked throughout their lifetime in comparison to those who have done little or no work outside the home. Because of this spousal benefit, the split of income between spouses can affect the equity of the benefits structure. To illustrate, a spouse who earns only a small fraction of the couple's earnings would not receive any more benefits than if

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he/she had not worked at all. Even working women who earn a more substantial percentage of the couple's earnings believe that they are not obtaining a fair return on their social security taxes because they frequently receive very little more in benefits than if they had not worked.

On the other hand, issues regarding the protection of the homemaker (whether part-time or full-time) have also received attention. Those who have worked little outside the home argue that they ought to obtain some benefits for their having maintained a home. Supporters of this position view the homemaker as making a contribution to the family which has a substantial economic value. An alternative line of thinking is that these spouses who have worked little outside the home are at greater risk of becoming poor in their later years. For these reasons, some believe that homemakers should have social security protection on their own right, and not as dependents of a spouse who is the primary earner.

Further, divorced spouses believe that the 50 percent benefit for which they might be eligible based on the primary contributor's earnings is inadequate. Widow(er)s under the age of 60 with no dependents under the age of 18 believe that they are short-changed because they receive no benefits.

In contrast, single workers sometimes object that one-earner married couples obtain a disproportionately high amount of benefits when the spousal benefit is included. Their argument is that the single worker and the earner in the one-earner married couple have contributed the same amount over the years, yet benefits for the single worker are much less.

Gender, Age, and Income Inequities

Differences can also occur as a result of gender, age, and income levels. Females' rates of return would be expected to be higher than those of males with the same income because their longer average life expectancy enables them to receive more benefits while contributions to the social security system are the same. Some may view this inequality to be offset somewhat by the fact that working women earn less than working men on average.

Age differences also introduce equity concerns. For an older individual, the old age and survivor insurance (OASI) contribution rate was as low as 1 percent for each of the employee and employer and remained below 3 percent until 1963 and below 4 percent until 1971. However, for a young person, this contribution rate would never have been less than 5 percent. Reinforcing this inequality is the fact that the maximum social security tax base was stable at relatively low

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levels for many years and then increased substantially in recent years. Specifically, the base was less than $5,000 until 1966, remained below $10,000 until 1973, and then increased significantly in later years as a result of legislation which mandated increases in this base in proportion to the increase in average earnings. Because older beneficiaries have contributed to the system at these lower rates and with these lower bases, they can be expected to have higher rates of return than younger beneficiaries.

The basic structure of the social security system also introduces inequities in benefits as a result of differences in income. Every social security beneficiary receives a guaranteed minimum benefit. Beyond this guaranteed minimum, increases in income lead to increases in benefits up to a maximum level of benefits. The result of this structure is a system that gives low-income recipients a higher than proportionate share of benefits.

Estimation Method

Computerized simulations on hypothetical single individuals and married couples are performed in order to determine the rates of return on social security contributions and to analyze the impact of a change in the benefits structure on the rates of return. Rates of return for both pre-tax and after-tax purposes are calculated. An examination of pre-tax rates of return on social security contributions facilitates a comparison with commonly quoted returns on alternative investments. However, it is also important to disclose after-tax returns because of the lower taxation of social security benefits as compared with ordinary income. In fact, prior to 1984, social security benefits were not taxed at all.

Taxation of Social Security Benefits

Legislation creating potential for taxation of social security benefits was enacted in 1983 for taxpayers starting in 1984. Through 1993, the amount of social security benefits an individual must include in income is the lesser of (1) one-half of the benefits received, or (2) one-half of the excess of the sum of modified adjusted gross income and one-half of social security benefits over a specified base (IRC Sec. 86). Through 1993, the base is $25,000 for a single individual or $32,000 for joint filers, and modified adjusted gross income is equal to the sum of adjusted gross income and tax-exempt interest.

Recent legislation included in the Revenue Reconciliation Act of 1993 significantly changed the taxation of social security benefits for higher income taxpayers beginning in 1994. The act defined modified

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adjusted gross income plus one-half of social security benefits as provisional income and stipulated that for taxpayers with provisional income above thresholds of $44,000 for married couples filing jointly and $34,000 for singles, taxable income includes the lesser of: (1) 85 percent of the taxpayer's social security benefit; or (2) the sum of 85 percent of the taxpayer's provisional income over the applicable new threshold amounts, plus the smaller of (a) the amount included under pre-1994 law, or (b) $6,000 for married couples filing jointly ($4,500 for singles). (Revenue Reconciliation Act of 1993, Sec. 13215(a) and (b) modifying IRC Sec. 86.)

Calculation of Rates of Return

The rate of return calculation for social security contributions involves many steps. Basically, the pre-tax rate of return is calculated by entering the contributions as negative values and the benefits received as positive values. The after-tax calculation involves subtracting the income tax liability on benefits received before entering them in the rate of return calculations.

For pre-tax purposes, to obtain the negative values or contributions, the lesser of the pre-retirement wages or the maximum effective taxable social security income base is multiplied by the applicable social security tax contribution rate in each year. The applicable contribution rate includes the OASI portion only, which has been 5.6 percent for each of the employee and employer (a total of 11.2 percent) since 1990. This measure excludes the disability income (DI) and medicare hospital insurance (HI) portions of the social security payroll tax.

To obtain the positive values in the rate of return analysis, social security benefits are computed for each hypothetical earner under each income level assumption through the PIA Calculation Program provided by the Social Security Administration. These benefits are then adjusted annually for changes in the Consumer Price Index for All Urban Consumers (CPI-U) from the time of retirement until the assumed death. Life expectancy varies depending on whether the person is male or female.

Simulations

Many assumptions are necessary for this analysis. The simulations include contributors of ages 25, 45, and 65 and are performed at various wage levels for 1990. The inclusion of individuals and couples of these ages represents well the impact of the alternative assumptions on social security recipients' rates of return. The persons ages 25, 45, and 65 are assumed to retire at their currently legislated "normal retirement" ages for social security recipients of 67, 66, and 65,

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respectively. "Normal retirement" is the first year in which an individual is eligible to retire without reduction in social security benefits.

Six 1990 wage levels for each of the hypothetical earners are included: $10,000, $20,000, $30,000, $50,000, $70,000, and $100,000.[1] Rates of return for two-earner couples are considered with two different income splits. For one couple, each spouse is assumed to earn 50 percent of the couple's total income ("50/50 split"); and, for the other couple, one spouse is assumed to earn 60 percent and the other spouse is assumed to earn 40 percent of the couple's total income ("60/40 split"). Other splits, of course, are possible, but these two seem to illustrate the controversy well. Married couples also include those with one earner because historically one spouse stayed home to care for children; and, despite significant demographic changes, a substantial number of households that fit this description still exists.

Earnings sharing has been proposed as a method of alleviating some of the concerns about the present system (HEW 1978; U.S. House of Representatives 1985). The concept of earnings sharing is similar to that of community property in that the combined earned income of husband and wife during the period of marriage is divided equally and shared between them for the purpose of calculating their social security benefits. Specifically, each spouse would be credited with one-half of the couple's social security earnings for each year of marriage. Thus, each spouse's social security benefits would be based on earnings for the years before marriage and shared earnings for the years of marriage. The benefits then are augmented by assumed factors to simulate policy aimed at minimizing the number of individuals who receive less than under current law. As an indication of the range of possibilities, the divided benefits for couples under the earnings sharing proposal are multiplied by 125 percent and 150 percent.

For all the simulations, wage levels are adjusted over time by the percent change in aggregate real wages in each year and the increase in the general level of prices (change in the CPI-U). Through 1992, actual increases in the CPI-U and real wages are used for this adjustment; thereafter, 4 percent inflation and .75 percent real wage increases each year are assumed. Each individual is assumed to work from age 20 until the time of retirement. For simplicity (primarily in calculating the impact of earnings sharing), couples are assumed to begin working at the time they are married.

In the first year of retirement, the total of after-retirement wages, pension income, other income, and social security benefits is assumed

[1]Although returns for other income levels were calculated, the levels reported are representative of the range of benefits.

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to be equal to 75 percent of the amount of pre-retirement income. The levels of other (nonwage) income for individuals and couples in each age and income class are based on the tabulations of income tax return data provided by the Joint Committee on Taxation of Congress (JCT) and are adjusted annually for inflation. This total is then adjusted by the growth in the consumer price index for the remaining years of retirement until assumed death. The single individual calculations are made for both males and females because their different life expectancies impact the rate of return calculations. Married beneficiaries are assumed to be the same age; the different life expectancies of the male and female spouse are considered (U.S. Department of Health and Human Services 1982). Using the above steps and the numerous described assumptions, the pre-tax internal rate of return is then calculated by entering the contributions as negative values and the benefits as positive values.

For the after-tax calculation, it is necessary to calculate modified adjusted gross income (or provisional income, as applicable), and this process necessitates an assumption about the amount of tax-exempt income. JCT tabulations show that tax-exempt income is common mainly for higher-income taxpayers and, accordingly, our study assumes that only higher income taxpayers have tax-exempt interest. The amount of this tax-exempt income rises with increases in income from other sources.

As outlined above, the resulting tax-exempt income is added to adjusted gross income and one-half of social security benefits to determine modified adjusted gross income (or provisional income). The income tax on the social security benefits paid by all the hypothetical taxpayers for all the income levels is calculated using pre-1994 and post-1993 law as applicable and then subtracted from benefits to arrive at after-tax benefits. Actual tax rates through 1993 are used for the analysis; all bracket and exemption amounts are indexed for each year thereafter. The after-tax internal rate of return is then calculated as in the pre-tax computation.

Rates of Return on Social Security Contributions

Economists recognize that in competitive markets, the incidence, or true burden, of the tax for social security is the same whether the employers or employees make the tax payment (Musgrave and Musgrave 1989: 440–41). When the employee bears the burden of the tax, employee wages are lower because employers have to match an employee contribution to the social security system. Assuming this

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is true, the combined employer-employee contribution is used in presenting the internal rates of return for this study.[2]

Pre-Tax Returns on Social Security Contributions for Recent Retirees

Rates of return were obtained for various alternative investments over time periods after World War II and then aggregated to give average rates of return. The investments include common stock, long-term corporate bonds, long-term government bonds, and U.S. Treasury bills. The purpose of including such a range of investments is to give the user a better means of comparing the value of one's investment in the social security system with that of different types of investments.

The returns on these forms of investment are determined by Ibbotson (1982, 1990) as follows. Common stock returns are based upon the Standard and Poor's (S&P) Composite Index which includes 500 of the largest companies (measured by stock market value) in the United States. The long-term corporate bond index is based on Salomon Brothers' High-Grade Long-Term Corporate Bond Index. The returns of long-term U.S. governments bonds are constructed from a bond portfolio using the bond data obtained from the Center for Research in Security Prices (CRSP) with the assumption of holding a 20-year life portfolio. The U.S. Treasury bill rates are calculated also from the CRSP U.S. Government Bond File assuming the shortest-term bill with not less than one month in maturity. We calculated the average rates of return for these investments for the total time period of 1945–89 and shorter time spans during that period as shown in Table 1.

A comparison of the pre-tax rates of return from the social security system (Tables 2, 3, and 4) with the average rates of return for alternative investments for the time period 1945–89 in Table 1 shows that the social security returns are very favorable. The returns for those retiring presently or in the near future are impressive. For 65-year-old couples (Table 2), the rates of return from the social security system range from 8.14 percent for 50/50 income split couples with 1990 incomes of $100,000 to 11.24 percent for one-earner couples with incomes of $10,000. These rates exceed those of all investments for the 1945–89 time period except the most risky, common stock,

[2]It is commonly assumed that workers bear the burden of payroll taxes. However, economists are not in complete agreement on this issue. Recognizing that some of the burden may fall on the employer as well, we also calculated rates of return assuming that the employer and employee share the burden of the tax equally. That is, we repeated the simulations using only the employee contributions. This process indicates that the basic conclusions of our study are not sensitive to this incidence issue.

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TABLE 1

AVERAGE RATES OF RETURN FOR ALTERNATIVE INVESTMENTS
(Percent)

Time Period	Common Stock	Long-Term Corporate Bonds	Long-Term Government Bonds	U.S. Treasury Bills
1945–89	13.57	5.42	5.03	4.74
1945–54	18.41	2.27	2.60	1.01
1955–64	14.06	2.80	1.86	2.58
1965–74	2.51	2.40	2.41	5.44
1975–84	15.66	9.21	7.73	8.87
1985–89	20.83	15.48	16.10	6.81

which had a rate of return of 13.57 percent. As predicted, couples with one earner have high rates of returns because they receive spousal benefits without making additional contributions. For 65-year-old singles, the rates of return ranging from 7.65 percent for a male beneficiary with income of $100,000 to 10.02 percent for a female with income of $10,000 are somewhat lower than for couples because of the lack of spousal benefits but still compare favorably with all investments except common stock. As anticipated, females have higher rates of return than males with the same income because of their longer life expectancy. Overall, the rates for many 65-year-old beneficiaries are almost twice as high as the average rates of return for long-term corporate bonds, long-term government bonds, and U.S. Treasury Bills for the 1945–89 time period.[3]

For 45-year-old couples (Table 3), the rates range from 5.39 percent for two-earner couples with incomes of $100,000 to 8.84 percent for one-earner couples with $10,000 income. For 25-year-old couples (Table 4), the rates range from 4.44 percent for two-earner couples with $100,000 income to 7.86 percent for one-earner couples with $10,000 income. For 45-year-old and 25-year-old singles, the rates are lower. No comparison with alternative investments is possible for

[3]The above comparison considers both employee and employer contributions to social security. However, most beneficiaries, uninformed about the incidence issue raised by economists, naively consider only their own portion of the social security tax when trying to determine the cost of their benefits. Whether or not this naive view is accurate, it is interesting to examine this case. For example, if employee contributions only are considered, the rates of return in Table 2 would be somewhat higher, ranging from 10.95 to 13.55 percent for 65-year-old couples, and from 10.62 to 12.36 percent for 65-year-old single individuals. These rates compare favorably even with rates of return for common stock investments.

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TABLE 2

PRE-TAX RATE OF RETURN FOR 65-YEAR OLDS ON SOCIAL SECURITY CONTRIBUTIONS
(Percent)

Income Level ($)	Single		Joint		
	Male	Female	One Earner	Two Earners (50/50)	Two Earners (60/40)
10,000	9.38	10.02	11.24	11.02	10.93
20,000	8.42	9.13	10.37	9.72	9.79
30,000	8.12	8.87	10.16	9.14	9.18
50,000	7.66	8.53	9.93	8.61	8.69
70,000	7.65	8.52	9.93	8.40	8.43
100,000	7.65	8.52	9.93	8.14	8.22

TABLE 3

PRE-TAX RATE OF RETURN FOR 45-YEAR OLDS ON SOCIAL SECURITY CONTRIBUTIONS
(Percent)

Income Level ($)	Single		Joint		
	Male	Female	One Earner	Two Earners (50/50)	Two Earners (60/40)
10,000	7.07	7.73	8.84	8.65	8.56
20,000	6.17	6.91	8.02	7.43	7.47
30,000	5.64	6.43	7.63	6.89	6.94
50,000	4.89	5.80	7.00	6.38	6.38
70,000	4.85	5.77	6.98	5.89	5.95
100,000	4.85	5.77	6.98	5.39	5.54

these younger beneficiaries. However, because expected inflation is assumed to be 4 percent per year, real returns on social security contributions will be positive in most every case.

After-Tax Rates of Return on Social Security Contributions

A comparison of the after-tax rates of return from the social security system with the average rate of inflation of 4.5 percent for the time period 1945–89 shows that the social security returns are very favorable. For 65-year-old couples, the nominal rates of return in Table 5

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TABLE 4

PRE-TAX RATE OF RETURN FOR 25-YEAR OLDS ON SOCIAL SECURITY CONTRIBUTIONS
(Percent)

	Single		Joint		
Income Level ($)	Male	Female	One Earner	Two Earners (50/50)	Two Earners (60/40)
10,000	6.19	6.85	7.86	7.67	7.59
20,000	5.36	6.09	7.12	6.56	6.59
30,000	4.82	5.59	6.72	6.06	6.10
50,000	3.95	4.81	5.86	5.58	5.57
70,000	3.91	4.78	5.81	5.05	5.08
100,000	3.91	4.78	5.80	4.44	4.61

range from 7.11 to 8.97 percent for those with 1990 incomes of $100,000 and are even higher for those with incomes of $10,000, from 10.93 to 11.24 percent. Rates of return for all income levels are much higher than inflation. In general, the returns are not as high for singles as for couples with the same income levels because of the lack of spousal benefits.

For 45-year-old couples (Table 6), rates of return range from 4.34 percent at $100,000 income level for a two-earner couple with a 50/50 split of income to 8.84 percent at the $10,000 income level for a one-earner couple. For 25-year-old couples (Table 7), rates of return range from 3.54 percent at $100,000 income level for a two-earner couple with a 50/50 split of income to 7.86 percent at the $10,000 level for a one-earner couple. In each of these age groups, the rates are lower for singles in virtually every case. Even after adjusting for the assumed 4 percent inflation, the 25- and 45-year-old contributors can expect positive real rates of return in virtually every case. Despite small differences, the real returns calculated from our nominal after-tax returns are similar to those calculated under somewhat different assumptions in Boskin, et al. (1987).

The nominal rates of return after considering the tax consequences to earners are even more impressive when examined relative to the returns from alternative investments. Dividends and interest from the alternative investments are fully taxed, while at most one-half of social security benefits have been subject to income taxation and this would occur only at higher income levels. Of course, the 1993 legislation to

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TABLE 5

AFTER-TAX RATE OF RETURN FOR 65-YEAR OLDS ON SOCIAL SECURITY CONTRIBUTIONS
(Percent)

	Single		Joint		
Income Level ($)	Male	Female	One Earner	Two Earners (50/50)	Two Earners (60/40)
10,000	9.38	10.02	11.24	11.02	10.93
20,000	8.42	9.13	10.37	9.72	9.79
30,000	8.05	8.77	10.16	9.14	9.18
50,000	6.57	7.54	9.78	8.51	8.57
70,000	6.41	7.40	9.00	7.68	7.70
100,000	6.41	7.40	8.97	7.11	7.20

TABLE 6

AFTER-TAX RATE OF RETURN FOR 45-YEAR OLDS ON SOCIAL SECURITY CONTRIBUTIONS
(Percent)

	Single		Joint		
Income Level ($)	Male	Female	One Earner	Two Earners (50/50)	Two Earners (60/40)
10,000	7.07	7.73	8.84	8.65	8.56
20,000	5.92	6.65	8.02	7.43	7.47
30,000	4.96	5.82	7.49	6.66	6.72
50,000	3.79	4.82	6.50	5.89	5.88
70,000	3.61	4.66	6.02	4.97	5.03
100,000	3.61	4.66	5.97	4.34	4.51

tax a greater amount of social security benefits will mean that the after-tax returns will be lower in the future.[4]

Earnings Sharing

As discussed earlier, policymakers have suggested that earnings sharing could simply be a computation of benefits based on split

[4]See Harmelink and Speyrer (1992) for a discussion of the effects of changing the taxation of social security benefits. Robert Genetski (1993) discusses one version of this proposal.

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TABLE 7

AFTER-TAX RATE OF RETURN FOR 25-YEAR OLDS ON SOCIAL SECURITY CONTRIBUTIONS
(Percent)

Income Level ($)	Single		Joint		
	Male	Female	One Earner	Two Earners (50/50)	Two Earners (60/40)
10,000	6.10	6.75	7.86	7.67	7.59
20,000	4.91	5.68	7.12	6.49	6.54
30,000	4.06	4.91	6.56	5.78	5.83
50,000	2.95	3.91	5.46	5.13	5.12
70,000	2.83	3.81	5.09	4.33	4.38
100,000	2.83	3.81	4.96	3.54	3.72

income during years of marriage. Some beneficiaries, especially those who had been receiving the spousal benefit, would be harmed by such treatment. They proposed augmenting the benefits by a factor equal to, say, 125 percent or 150 percent (HEW 1978: 56). Table 8 shows that such an augmentation is not really necessary at all at income levels of $50,000 or above. In addition, Table 8 shows that lower income couples would be over-compensated even with the lower augmentation factor of 125 percent. In addition, simple sharing of earnings leads to a higher rate of return than current law in virtually

TABLE 8

AFTER-TAX RATE OF RETURN ON SOCIAL SECURITY CONTRIBUTIONS: EARNINGS SHARING FOR MARRIED 65-YEAR OLDS
(Percent)

Income Level ($)	Joint: One Earner	Earnings Shared		
		100 Percent	125 Percent	150 Percent
10,000	11.24	11.02	11.79	12.40
20,000	10.37	9.72	10.52	11.16
30,000	10.16	9.51	10.34	11.00
50,000	9.78	9.78	10.79	11.58
70,000	9.00	9.81	10.70	11.41
100,000	8.97	9.98	10.86	11.56

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every case for the couple with a 60/40 income split. These observations suggest that earnings sharing would not be a hardship for most couples and may actually improve the rate of return on social security contributions for some. The 150 percent earnings sharing alternative is overly generous to the contributors and would financially burden the social security system.

Policy Implications

This article has discussed four different inequities in the social security system: marital status, gender, age, and income. Marital status appears to be the most important when considering the attention the issue has received in the literature. Rates of return for one-earner couples are up to 40 percent higher than for two-earner couples and up to 85 percent higher than for single males. Some form of earnings sharing may help alleviate some of this difference. However, the augmentation of benefits under the programs suggested by the HEW study (1978) may be unnecessary, especially for high-income recipients. Administrative problems of converting to an equitable earnings sharing system, however, could be significant, especially when considering transition rules, contribution rates of spouses who do not work outside the home, etc. The payoff would be that couples with the same total earnings would receive the same total benefits regardless of whether the couple had one or two earners. Importantly, however, because the social security system provides a minimum benefit for each recipient, earnings sharing does not solve the problem of the single (individual) earner in comparison to the one-earner couple (who would receive minimum benefits for each spouse).

If policymakers are serious about solving the inequities based on marital status, an alternative approach to solving the problem is to move toward a social security system that bases all benefits on each individual's contributions. This would mean that the spousal, widow, and divorcee benefits based on that of a primary earner's contributions would be eliminated. One way to address the spousal, widow, and divorcee needs in this revised system would be to divide the total social security contribution rate into segments. Currently the 7.65 percent rate is divided into OASI, DI, and HI portions. The revised system might include a separate "premium" to cover the spousal, widow, or divorcee benefits which could be "purchased" at the option of the contributor. This would eliminate the inequities based on marital status, yet provide contributors with the opportunity to accommodate spouses who do not work outside the home, widow(er)s, and divorcees.

Our study shows that younger earners will experience lower rates of return than current retirees. The nominal rates of return for

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65-year-old contributors are up to 126 percent higher than for 25-year-old contributors. Because older beneficiaries have contributed to the system at lower rates and with lower bases, contributions to social security were clearly a much better investment for persons retiring in 1990 compared to those expecting to retire in 2011 and 2032. The problem is that reducing contribution rates will negatively affect the solvency of the social security system; on the other hand, if benefits are reduced, the welfare of social security recipents will decline. As long as current retirees receive benefits based upon the present cohort of working individuals rather than upon the value of their own contributions, this inequity will prevail. Therefore, in order to reduce differences due to age (like the marital status differences described above), more attention needs to be paid to the individual contributor's account (i.e., the accumulation of the contributions over time). That is, rather than having present contributors funding the benefits for present recipients, the present recipients might be restricted to receiving benefits solely on the basis of their contributions (perhaps with some allowance for minimum benefits and some cap or maximum on benefits). The basing of benefits on the amount of contributions would make the system more like a private pension system and would assist in providing for the solvency of the social security system.

Admittedly, transitional problems would exist in moving to a system where more emphasis is on the individual contributor's accumulations in the social security account. However, these costs would be offset by the benefits of greater fairness and increased solvency of the social security system.

A more radical proposal to eliminate the age discrimination would be to allow individuals to choose to contribute to a private pension plan rather than the social security system. That is, individuals who were able to contribute a minimum required amount through their employers' private pension plans could do so. Under such a system, self-employed persons could be given the opportunity to contribute a higher amount to either a private program or to the social security system. Any individuals not eligible for employers' plans would contribute through the governmental social security system. Although this approach has had some success in Chile (Genetski 1993), it has significant difficulties, not the least of which is the future viability of the social security system.

As income increases, rates of return consistently decline for the contributors in our study, regardless of age. Rates of return for earners with $10,000 are up to 117 percent higher than for those with $100,000

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income. The differences based on income are sizable, but this degree of progressivity may be justifiable on other grounds.

Relative to the gender issue, in no case is the rate of return of the female more than 35 percent higher than for the male. Although this difference is substantial, the gender differences are not as high as the differences based on marital status, age, and income. In fact, it is conceivable that as the future life expectancies of the female come closer to males, as is predicted, this differential could become smaller.

Conclusion

In order to alleviate the bias of the current system, it will be necessary to make some major changes in the social security system. While the gender difference will likely diminish over time and the income inequity will be present as long as progressivity is a generally accepted concept, marital status and age problems will continue to haunt the present benefits structure. Earnings sharing, a proposal suggested as early as 1978, goes a long way to address the problems among couples with different income splits. However, it does little to solve the inequities between couples and individuals with equal earnings and does nothing to solve the inequality of treatment for people of different ages. A move to basing benefits on an individual's contributions, with an opportunity to adjust for special needs of spouses, widow(er)s, and divorcees through the purchase of such coverage, could, in the long run, be a workable solution to the marital status and age inequities, the two most serious of the four concerns identified in this article.

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Regulation and Economic Performance: Lessons From the States

Robert Krol and Shirley Svorny

Significant progress has been made in deregulating the economy at the federal level. Beginning with the Carter Administration, federal laws governing interstate trucking, railroads, energy, and financial markets were changed to increase competition in those sectors. Clifford Winston (1993) has reviewed the progress made in deregulation at the federal level. The purpose of our paper is to focus on state government regulation. We review evidence on the economic consequences of state banking regulations, trucking regulations, environmental regulations, and labor market regulations. Such regulations interfere with competitive market processes by restricting entry and controlling prices.[1]

A comprehensive review of the existing empirical literature on state regulation shows that it can raise business costs and limit competition in addition to generating negative employment and output effects. Observing the results of state regulatory "experiments" provides a powerful illustration of the dubious consequences of policy activism.

At this time, state government officials are under pressure to intervene to improve economic performance. The studies reviewed here suggest that one policy option is deregulation.

Banking Regulation

There is empirical evidence that state restrictions on bank activities—such as within-state branch banking and interstate banking—

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[1]Evidence on the impact of state taxation and infrastructure investment is not included. While very topical, those areas have been surveyed by Timothy Bartik (1991) and Charles Hulten and Robert Schwab (1993). Also, evidence on the effects of right-to-work laws is not included. Those effects are reviewed by William Moore and Robert Newman (1985). They conclude that it is not right-to-work laws but the extent of unionism in a state that affects union membership, wages, and industry location.

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increase bank costs and reduce competition. Economic theory predicts that high costs and lack of competition will reduce banks' ability or willingness to lend, reducing the quantity of credit available to investors through financial institutions. Because credit availability is critical to investment and growth, this restriction on lending should have an adverse affect on economic activity.

Evidence of the effect of bank regulation on bank costs is presented by Mark Flannery (1984). He estimates cost and profit functions and finds that restrictions on branch banking result in higher costs. The literature on cost advantages of size (economies of scale) in banking also finds that branch banking decreases bank costs (Humphrey 1990). Stephen Rhoades (1982) provides evidence showing banking output (loans) in states that prohibit branching to be significantly below levels likely to occur in a competitive environment. On the other hand, branch banking was found to have a positive and significant effect on small business starts at the state level (Bartik 1989).

In a recent article (Krol and Svorny 1994), we examined the impact of state bank regulations that govern interstate banking, intrastate branching, and bank holding company activity. The study covers the period from 1970 to 1988, a period of substantial change in state banking laws. After controlling for observed and unobserved differences in state economies, we found that those states with greater restrictions on bank activity experienced inferior economic performance (as measured by real per capita personal income). The implications of these results are clear: eliminating restrictions on banking activitiy would improve the economic climate in the state and increase economic activity.

Trucking Regulation

The Motor Carrier Act of 1980 passed by Congress significantly weakened the regulation of interstate trucking. Effectively, it gave firms increased freedom to enter and exit interstate trucking markets. In addition, it substantially altered the administration of rate setting. As a result, rates on interstate trucking decreased without any noticeable deterioration in quality of service (for details, see Moore 1986). The predictions of economic theory regarding trucking deregulation are straightforward: a reduction in transportation costs should increase economic activity.

Following interstate deregulation, a number of states deregulated *intra*state trucking. Deregulation of intrastate trucking occurred in Florida in 1980, in Maine and Arizona in 1982, and more recently in

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Alaska, Delaware, Vermont, New Jersey, and Wisconsin.[2] Other states are sure to follow suit.

Recent studies by Roger Blair, David Kaserman, and James McClave (1986) and Richard Beilock and James Freeman (1987) examine the impact of intrastate trucking deregulation on carrier rates. Blair, Kaserman and McClave examine the impact of deregulation in Florida while Beilock and Freeman look at Florida and Arizona.

Before deregulation in January 1980, prices and entry in Florida were set by the state's Public Service Commission. There were also controls on areas served, backhauls, types of vehicles, commodities hauled, and customer service coverage. Blair, Kaserman and McClave looked at 10 carriers for 2 years following deregulation. They observed a decline in rates of almost 15 percent. Prices in large markets declined more than in small markets, suggesting that regulators may have been setting rates in a manner that subsidized small markets at the expense of larger ones.

The study by Beilock and Freeman examined data for both Arizona and Florida. Their regression results are unclear about the impact of deregulation, but a comparison of average rates before and after deregulation shows a decline in rates, especially in Florida.

Finally, Clifford Winston et al. (1990) estimate a model of trucking rates based on input prices and shipment characteristics (such as load size) for the deregulated *inter*state trucking market. They combine the estimate of this model with corresponding data on *intra*state trucking in California and Nebraska to forecast intrastate rates in a deregulated environment. For shipments less then 10 thousand pounds, they find that deregulation of intrastate trucking would lead to a 30 percent reduction in shipping rates.

Environmental Regulation

Environmental regulation is in direct response to the negative side-effects (externalities) that result from pollution. Government efforts to restrict emissions will, by definition, diminish economic activity. Two studies attempt to quantify the effect of pollution control requirements on economic activity. Using standard metropolitan statistical area (SMSA) level data, Kevin Duffy-Deno (1992) finds weak support for the argument that environmental regulations retard manufacturing activity. Similarly, Timothy Bartik (1988) finds no effect of environmental regulation on business location decisions.

[2]The District of Columbia also has deregulated trucking. Cassandra Moore (1994) provides an overview of recent attempts in state legislatures to deregulate intrastate trucking.

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Those tests are constrained, however, by the lack of a useful measure of environmental regulation. Both studies use pollution abatement expenditures to measure the strictness of the regulatory environment. (Bartik also looks at three other measures.) This approach creates problems because federal law requires stricter controls over new firms. As a result, empirical tests are biased toward finding a positive association between high abatement costs and job growth.

Bartik (1988) emphasizes that the variety in state regulations makes it difficult to focus on a single measure of the strictness of state rules. Also, substantial variations in enforcement across states make statutory regulations an imperfect measure of the actual severity of state environmental laws.

Instead of looking at the relation between controls and economic activity, it is more useful from a policy perspective to focus on the cost savings associated with alternative methods of control. There have been many attempts to measure, through mathematical simulations, the benefits of alternative methods of control (Teitenberg 1985, 1987). In addition, there are transactions data on emissions trading that reveal substantial cost savings (Teitenberg 1985).

Emission trading encourages innovation in emission control and shifts pollution abatement to those firms for which the costs of abatement are lowest. Thus, many economists have suggested that emissions trading arrangements are a way for states to reduce pollution abatement costs and encourage economic growth.

Labor Markets

Minimum Wage Legislation

Individual states may set minimum wages that exceed the federal minimum. The decade of the 1980s was unusual in that the federal minimum wage remained constant. As inflation reduced the purchasing power of the minimum wage during that period, 12 states (and the District of Columbia) chose to set state minimum wages above the federal level (Neumark and Wascher 1992).

Economic theory is clear on the expected effect of a minimum wage: higher wages will reduce the amount of unskilled labor that firms choose to hire. Benefits accrue to those workers who obtain employment at the higher wage, but fewer unskilled workers will find employment opportunities open to them. As the economy grows, the number of jobs grows, so the effect of an increase in the minimum wage will not be a reduction in employment but rather a slower rate of growth. Statistical techniques have allowed economists to isolate the effects of changes in the state minimum wage on employment.

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Daniel Neumark and William Wascher (1992) find evidence that a 10-percent increase in a state's minimum wage reduces teenage employment by 1 to 3 percent. This finding is consistent with evidence from time-series studies of the U.S. economy as a whole (Brown, Gilroy, and Kohen 1983). Since not all teenagers are employed at the minimum wage and not all industries are covered by the minimum wage, the negative effect on those individuals actually employed at the minimum wage is even larger (Brown 1988). States intent on promoting economic growth may find that a relatively high minimum wage works against their goals.

Three recent empirical studies have received attention because they find little or no adverse effects of an increase in the minimum wage on employment (Card 1992a, 1992b; Katz and Krueger 1992). One would expect large increases in the minimum wage to reduce employment, but results from these studies suggest that small increases may have little or no effect in the short-run or that they may even cause minimum wage employment to increase. Understandably these findings have generated intense debate among labor economists, many of whom are concerned that policy decisions could be based on potentially flawed results. Critics argue that some of these studies (e.g., the Katz and Krueger study) fail to control for other factors that may have influenced employment. Focusing on the changes in labor demand immediately following the change in the minimum wage (as in Card 1992a and 1992b) may also obscure results since adjustment costs may preclude immediate reductions in a firms' labor demand. Card's study of employment in California (1992a) finds an adverse effect of an increase in the minimum wage on teenage employment in eating and drinking establishments only, but not in other areas of employment. This result may be explained by the fact that minimum wage laws are possibly enforced more strictly in eating and drinking establishments than elsewhere. However this debate is resolved, it is hard to believe that the overwhelming evidence of a *negative* relation between employment and wage increases will be overturned. The law of demand is just as applicable to the labor market as it is to the product market. No one has shown convincingly that the price of labor has no effect on the number of jobs and economic activity.

State Fringe Benefit Mandates

Economists have pointed to state mandates of employee benefits as being deleterious to employment and economic growth. Economic theory suggests that firms faced with high costs of labor will hire fewer workers and work the remaining workers longer hours to reduce the burden of state-mandated fringe benefits. Because such mandates

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raise firms' costs, they reduce the competitiveness of firms subject to the mandates in national and international markets, further reducing state employment.

Jonathan Gruber and Alan Krueger (1991) look at the effect of mandated workers' compensation insurance costs on state employment. Variations in state programs allow an analysis of the effect of workers' compensation on employment. Based on admittedly "extremely imprecise estimates," Gruber and Krueger report that a 1 percent increase in workers' compensation rates causes employment to decline by .11 percent.

A study by Gruber (1992) provides stronger evidence of negative labor force effects of mandated benefits. Looking at three states that mandated health insurance benefits for maternity, Gruber finds that employment falls for that portion of the labor force to which this benefit would apply (young women and their husbands). As with minimum wage legislation, decisionmakers must weigh the benefits of mandated benefits against the costs—a reduction in state employment opportunities.

Wrongful Termination Protection

Changes in laws involving the relation between workers and their firms can have a significant impact on employment. An area of labor law that has received considerable attention recently is wrongful termination protection. Many state courts and legislatures have moved away from the common law "employment-at-will" doctrine. This doctrine has been historically interpreted to mean that employment is for an indefinite period and there are few restrictions on the basis of termination by the employer, the exceptions being a contract or a specific statue. Many states have reevaluated the employment-at-will doctrine and have expanded wrongful termination doctrines. This change has resulted in a significant increase in employer liability.

The reasons for these changes and their impact on employment have been carefully evaluated in a study by James Dertouzos and Lynn Karoly (1993). Dertouzos and Karoly find states are more likely to adopt wrongful termination laws where unionization has declined, where there are no right-to-work laws, where the lawyer-per-capita ratio is high, and where neighboring states have already adopted a similar law.

Most important for this review is their analysis of the impact of those legal changes on employment. Economic theory suggests that such changes will negatively impact state employment. The reason is simple, wrongful termination protection raises the relative cost of labor. Firms will tend to spend more time and dollars screening

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potential employees, fail to terminate lower productivity workers, and have greater legal expenses.

After carefully controlling for differences across states, Dertouzos and Karoly find that the adoption of wrongful termination laws reduces state employment between 2 and 5 percent. The impact appears to be smallest in manufacturing, where unions have already institutionalized many protections, and in small firms, perhaps because those firms' smaller net assets make it less profitable for employees to file wrongful termination suits.

State courts must weigh the benefits of protecting worker rights with increased worker compensation rules against the cost in terms of reduced employment. In addition, the courts and lawmakers need to recognize that firms have incentives to establish internal worker appeal systems where workers find them of value.

Regulation of the Professions

There is evidence that state regulation of professions including medical doctors, dentists, lawyers, electricians, and plumbers raises costs to consumers. Although the effect of any particular restriction on aggregate state economic activity is hard to measure, economists generally think that state-imposed barriers to entry increase prices and reduce competition in the relevant market. This result is in direct contrast with a world in which low prices and widely available services facilitate economic growth and well-being.

Jeffrey Perloff (1980) shows that local and state licensing laws that limit the number of electricians and plumbers (through entry restrictions) insulate wages of those groups from general movements in wages, preventing the equalization of wages between those groups and similar workers that leads to the efficient use of labor. B. Peter Pashigian (1979) finds that licensure limits the efficient mobility of lawyers across states.

Looking at dental markets, Arthur DeVany (1982) reports that state restrictions on the use of paradentals have resulted in dentist-paradental ratios that are higher than in states without such restrictions; evidence that restrictions limit the efficient combination of labor. Lawrence Shepard (1978) shows that dental fees are significantly higher in states unwilling to automatically license dentists licensed in other states. Those states also employ fewer dentists.

Medical markets also are affected by regulation at the state level. Lee Benham (1972) presents evidence that restrictions on advertising by optometrists raise prices of eyeglasses significantly in areas where such advertising is prohibited. Shirley Svorny (1987) finds that states using superfluous medical licensure restrictions in the mid-1960s

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(citizenship and anachronistic basic science certification requirements) had relatively fewer physicians per capita.

While some professional regulation or certification may properly fall to the state government, it appears that many regulations restrict the efficient use of resources. States seeking to enhance economic well-being should consider revising their professional statutes to promote entry and competition.

Conclusion

It is important to be aware of the consequences of government actions. Quantification is a first step toward providing policymakers with information that will allow them to make balanced decisions. Most areas of government regulation of markets have not been the subject of careful empirical tests—evaluation is often constrained by lack of useful data. The research findings that do exist, however, support the idea that elimination of regulatory constraints should be considered by politicians interested in enhancing the level of economic activity in their state.

The studies reviewed here suggest that allowing interstate and intrastate branch banking, deregulating intrastate trucking, allowing states to choose low-cost strategies for pollution abatement, ending distortions in the labor markets caused by the minimum wage and occupational licensing, and limiting mandated benefits and wrongful termination protection, are among the policies that can contribute to improved state economic performance. There are, of course, additional potential gains in other regulatory areas that have not been the subject of empirical analysis.

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Overinvestment in Public Sector Capital

Willis Peterson

There appears to be widespread agreement that more spending on education and infrastructure is a good thing. For the most part, this requires public investment. If the objective is to increase economic growth, allocating more resources to investment is, of course, necessary. However, given the resources available for adding to the stock of capital, economic growth will be maximized only if marginal rates of return on alternative forms of capital are equalized. The results presented here suggest that large differences exist in the marginal rates of return on various forms of capital. Of particular concern is the low estimated return on public capital relative to private capital.

Capital Measurement

In this study, capital is grouped two ways: private versus public, and non-human versus human. Each group sums to the same total. Public investment in science and education is used as an estimate of human capital. Public sector capital includes both human and nonhuman forms. Stocks of nonhuman capital include both private and public sources.

The main difficulty of measuring the stock of capital is the assessment of depreciation. When capital is used as an input in a production function, true depreciation should reflect the decline in its service flow as aging takes place. Theoretically, the market price of a capital item is the discounted present value of the sum of future service flows. This value declines as the item ages not only because of a decline in productivity, but also because it has fewer years of useful life remaining. A decrease in market value will occur even if the rate of service flow does not decline. Therefore, a measure of the service flow of capital based on current market value of the capital stock will understate the true service flow. Book value of capital also will

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understate its true service flow capacity because of the incentive by business firms to depreciate capital at the maximum allowable rate for income tax purposes.

The depreciation method adopted here is the "one horse shay" pattern. Under this method the service flow of a capital item is assumed to remain constant over its life and then fall to zero at the end. Although the true decrease in service flow of capital over time cannot be known, the one horse shay pattern of depreciation probably comes closer to the true pattern than the other two alternatives (Griliches 1963).

For private capital, 15 years is selected as the average life expectancy. Some capital, such as buildings, last longer while other items, such as certain machines and tools, have shorter life spans. But as an overall average, 15 years is not an unreasonable figure. The stock of private capital in year t (K^t) is constructed by summing real gross private domestic investment (GDI) over the preceding 15 years.

Capital constructed by public investment is estimated in a similar manner except its life span is assumed to be 20 years. Public investment by state and local governments and the federal government consists largely of buildings, infrastructure, education, and science, all of which should be somewhat more durable than machines.

Capital constructed by state and local governments is assumed to be the result of expenditures on education and highways, plus one-half of all other spending. The latter includes the following: libraries, hospitals, health, employment security administration, veteran's services, air transportation, water transport and terminals, parking facilities, transit subsidies, police and fire protection, correctional institutions, protective inspection and regulation, sewerage, natural resources, parks and recreation, housing and community development, solid waste management, financial administration, judicial and legal, general public buildings, other government administration, interest on debt, and other miscellaneous expenditures. Data on state and local government investment spending and gross private domestic investment are from the *Economic Report of the President* (1992, and back issues).

Capital constructed by the federal government is assumed to result from spending on public buildings, transportation, education, community development, land and water conservation and development, health research, river and harbor facilities, general science and space research, and other public works. Data on federal government expenditures are from the *Statistical Abstract*, various issues.

Stocks of human capital are estimated by aggregating the spending of state and local governments and the federal government on education,

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science, and health research. The same 20-year life is assumed. The true stock of human capital is understated because the estimated stock does not include tuition payments, books and supplies, and forgone earnings of students. Data on these items do not exist.

Measuring capital as the sum of past investments implicitly takes quality change into account. If higher quality capital is more costly to produce, it will show up as more capital. On the other hand, any efficiency gains in the production of capital of a given quality would result in a higher rate of return. Conversely, an increase in the real cost of producing capital of a given quality, or a decrease in its quality for a given cost, will show up as a decrease in its rate of return.

To facilitate comparisons over time, GDP and the capital variables, except human capital, are expressed on a per worker basis. Because investment in education is not limited to members of the labor force, per worker figures on human capital are obtained by dividing the total stock of human capital by the population 5 years old and older. Per worker figures of the other capital variables are obtained by dividing the totals by the number of employed people in the country. All GDI and government spending figures are adjusted to constant 1987 prices before summing. The GDI figures are adjusted by the implicit price deflator for fixed investment. State and local government spending on highways is deflated by the Producer Price Index for construction materials. Educational expenditures are deflated by the Consumer Price Index for nonmedical services. And federal government investment spending is adjusted by an average of the preceding two indexes.

Capital Stocks

Estimated capital stocks per worker in thousands of 1987 dollars for selected years are presented in Table 1. In 1990, each U.S. worker on average is estimated to have had $123 thousand of capital at his/her disposal. Roughly 67 percent was from private investment and 33 percent from public sources. About 83 percent was nonhuman capital and 17 percent human capital, although, as mentioned, the human capital figure is a lower bound. In all categories, the 1990 per worker stocks were the largest that existed any year in the 1950–90 period, and presumably were the largest for any year in the history of the country.

The figures in Table 1 compare favorably with Musgrave's estimates presented in the *Survey of Current Business* (U.S. Department of Commerce 1992). His 1990 estimate of net private capital converted to a per worker basis is $73.4 thousand, compared to $82.4 thousand in Table 1. (Both sets of figures are in constant 1987 dollars.) His gross private capital estimate is $122 thousand per worker. Thus

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TABLE 1

ESTIMATED CAPITAL STOCKS PER WORKER
(Constant 1987 Dollars, Thousands)

	1950	1960	1970	1980	1990
Total Capital	43.6	68.5	86.2	109.0	123.0
Private Capital	33.8	54.5	63.3	74.6	82.4
Public Capital	9.8	14.0	22.9	34.4	40.6
Nonhuman Capital	39.9	62.2	74.7	90.3	101.6
Human Capital	3.7	6.3	11.5	18.7	21.4

Musgrave's estimates of private capital encompass those presented in Table 1.

Because Musgrave's government capital estimates exclude public investment in human capital, the *Survey of Current Business* figures for government capital are not comparable to the estimates of public capital shown in Table 1, which include both human and nonhuman forms. Subtracting human capital from public capital for 1990 in Table 1 yields a per worker estimate of $19.2 thousand. Musgrave's 1990 estimates for net and gross government capital converted to a per worker basis are $20.3 and $34.5 thousand respectively. Thus his net figure is close to the figure obtained in this study after subtracting human capital.

As shown by the numbers in Table 1, components of the total capital stock grew at varying rates over the 1950–90 period. Public capital increased relative to private capital, and human capital grew more rapidly than nonhuman. This can be seen more clearly from Table 2 which shows the average annual growth rates by decades of the figures in Table 1, plus real GDP per worker and employment. Total capital exhibited the most rapid growth during the 1950s, mainly due to the high rate of gross private domestic investment. The decade of the 1950s appears to be a catching-up period after the unusual circumstances of the preceding two decades—the Great Depression and World War II. Over the entire period, highest growth rates occurred in public capital and human capital. Public capital grew at a rate nearly twice that of private capital over the 1950–90 period. Lower rates of growth of the total and various components of the total stock of capital occurred in the 1980s than anytime during the post World War II era. Employment growth was the greatest during the 1970s as homemakers and baby boomers came into the labor force.

Capital Productivity

As shown in Table 2, during the 1950–90 period, total capital per worker increased at an annual rate that was nearly double the growth

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TABLE 2

ANNUAL PERCENTAGE RATES OF GROWTH OF ESTIMATED CAPITAL PER WORKER, REAL GDP PER WORKER, AND EMPLOYMENT BY DECADES[a]

	1950–59	1960–69	1970–79	1980–90	1950–90
Total Capital	4.35	2.15	1.95	1.05	2.51
Private Capital	4.53	1.34	1.58	.764	1.98
Public Capital	3.60	4.89	4.24	1.64	3.95
Nonhuman Capital	4.27	1.66	1.86	.994	2.17
Human Capital	5.03	6.13	5.01	1.34	4.85
Real GDP	1.77	2.47	.388	1.98	1.16
Employment	.99	2.01	2.47	1.98	1.84

[a]Estimated by $\log X_t = A + bT$ where X_t is the item under consideration, T is time, and b is the annual percent rate of growth.

rate of real GDP per worker. This implies a decrease in the productivity of capital. At the same time, capital increased relative to labor. Therefore, labor productivity should have increased, which is consistent with the growth in real GDP per worker.

The productivity of capital is commonly gauged by its marginal rate of return, estimated here by a standard Cobb-Douglas production function. The constant returns to scale assumption is imposed because the observations are per country as opposed to per firm. Time series data are utilized, 1950 to 1990. To minimize the problem of multicollinearity, a common problem with time series data, the labor intensive form is utilized.

Output per unit of labor, Q/L, is real GDP divided by total employment. Three functions are estimated where inputs are defined as: (1) total capital per worker, (2) private and public capital per worker, and (3) nonhuman and human capital per worker. To test whether the coefficient on capital has changed over the 1950–90 period, decade-specific slope dummies were inserted in the function, using the 1950–59 decade as the reference dummy. None of the slope dummy coefficients was statistically significant at reasonable confidence intervals, suggesting a constant coefficient on capital over the 41-year period. This finding is consistent with the Cobb-Douglas functional form which stipulates constant coefficients in the face of changing relative prices and a changing input mix (Douglas 1948).

Since capital is measured as a stock, the marginal products are marginal rates of return (MRR). They are also social rather than private returns since output is gross of taxes. Estimated MRRs for the various capital measures for each of the four decades are presented

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TABLE 3

ESTIMATED MARGINAL RATES OF RETURN ON CAPITAL BY DECADES
(Percent Per Year)

	1950–59	1960–69	1970–79	1980–90
Total Capital	23.8	21.0	18.1	15.8
Private Capital	28.6	25.7	24.2	22.1
Public Capital	17.7	14.5	7.7	7.0
Nonhuman Capital	21.3	19.3	17.5	15.7
Human Capital	41.7	29.0	18.0	13.8

in Table 3. Marginal rates of return on total capital and its components were the highest during the 1950s and have declined over each of the following three decades. Although the rate of return on human capital was nearly double the return on nonhuman capital during the 1950s, the 1980s figures suggest that the rate of return on human capital has fallen more and was less than the marginal return on nonhuman capital during the 1980s. Similarly the return on public capital has fallen relative to the return on private capital. These results are not unexpected since the stocks of both human and public capital have grown relative to those of nonhuman and private capital.

Although there are no studies directly comparable to this one, the results obtained here are not unreasonable, nor are they out of line with previous findings. The 15.8 percent estimated marginal rate of return on all capital during the 1980s compares closely with the 15 percent rule-of-thumb commonly used as the social opportunity cost of capital. Also the 13.8 percent marginal return on human capital for the 1980s is close to what one obtains when calculating the returns to investment in education using earnings differentials from census data. In a 1989 study using international data, the marginal rate of return on capital for the developed countries was reported to be 15 percent (Peterson 1989). Finally, in a recent study, Summers also reports a decline of the social rate of return on capital in the private sector over the 1950–1987 period (Summers 1990). However, the low estimated returns to private capital reported in the Summers study, 6.4 percent during the 1980s, are not plausible. Investment should not occur when the rate of return on capital is less than the interest rate on loan funds.

Labor Productivity

The marginal product of labor also is estimated from the production functions. Marginal products of labor for the four decades are shown below in Table 4.

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TABLE 4

ESTIMATED MARGINAL PRODUCTS OF LABOR
(Constant 1987 Dollars, Thousands)

Period	Marginal Products
1950–59	14.7
1960–69	18.2
1970–79	20.2
1980–90	21.2

Although the marginal product of labor has continued to increase over time, the difference between each succeeding decade has become smaller. The greatest growth in labor productivity occurred during the 1950s. The continued increase in the stock of capital per worker over the period which increases labor's marginal product has been offset in part by the decrease in capital productivity.

Conclusion

The relative decline in the estimated marginal rates of return on human and public capital to levels below the return to nonhuman and private capital is cause for concern, particularly if one takes seriously the call for an increase in spending on education and infrastructure. This is not to deny the enormous contribution to economic growth of inframarginal investments in education and infrastructure. But we are talking here about investments at the margin.

The relative increase in the stocks of public and human capital along with the decline in their marginal rates of return below the returns to private and nonhuman capital suggest the existence of an imbalance in the optimal mix of capital. These results suggest that policies that encourage the relative growth of private and nonhuman capital would do the most to stimulate economic growth and reduce unemployment. Such policies might include greater reliance on expenditure taxes and less on income taxes, and/or a reinstatement of the investment credit provision in the income tax code. It is commonly assumed that higher rates of economic growth depend upon an increased investment in education and infrastructure. Thus the implications of the results reported here run counter to conventional wisdom. Yet it might be noted that higher rates of economic growth do not necessarily require larger stocks of public sector and human capital. During the 1960s the growth rate of real GDP per worker was over twice the rates of the 1970s and 1980s. However, in 1960, estimated

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per worker stocks of public sector and human capital were about one-third 1990 stocks in real terms (Table 1). Also, GDP growth in the 1970s was relatively low while the growth rates of public sector and human capital remained high (Table 2).

Granted, society may have objectives other than, or in addition to, higher rates of economic growth, such as full employment and a more equal distribution of income. In this case, the marginal rate of return on capital is not the only criterion for resource allocation policy (Harberger 1971). But again it might be noted that the relative increase in the stocks of human and public sector capital has not prevented the trend towards less equality of incomes, nor of higher rates of unemployment in the 1990s than prevailed in the 1950s and 1960s.

What does the future hold in store? Will future generations be worse off, as some have suggested? As long as gross investment per worker exceeds depreciation, the per worker stock of capital will continue to grow. Unless the marginal rate of return decreases at a faster rate, total output per worker will increase. One would not expect marginal rates of return on capital to decrease indefinitely. At some point, owners of capital will seek higher returns in other countries. When, or if, this occurs, the marginal rate of return on capital and capital per worker should stabilize, along with output per worker. Thus future generations need not be worse off than current or past generations. But the evidence does suggest that future generations will not be getting better off at as rapid a rate as past generations. Even if the rate of investment increases during the mid to late 1990s, capital stocks take much longer to respond. Thus the immediate prospects for higher, sustained economic growth do not look promising. Future generations will bear the consequences of the investment slowdown of the 1980s, particularly in private and nonhuman capital.

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Reverse Revenue Sharing: A Return to Fiscal Federalism

Dwight R. Lee

The federal government has assumed so many responsibilities for so many diverse problems that it no longer has the ability to do anything well. The real cause of gridlock in Washington is not the system of checks and balances that restrains the activity of government, but the lack of restraint on a federal government that is accomplishing so little because it is attempting so much. This gridlock will not be reduced by one-party rule in the nation's capital. The opposite is more likely the case. Unless the federal government concentrates on the few things that need to be done collectively, and can only be properly done centrally, the gridlock of inefficiency will remain the hallmark of Washington. But any attempt to prune the activities of the federal government will meet head on with another hallmark of the nation's capital, entrenched special interests. Every federal program, no matter how inappropriate its purpose as a federal responsibility or how counter-productive in achieving that purpose, is championed by an organized interest group that benefits not just from the existence of the program but also from having it controlled and financed from Washington. Any attempt to eliminate a federal program, or shift responsibility for it to the state or local level, is sure to be frustrated by intense special-interest opposition.

Overcoming special-interest influence, and reversing the proliferation of federal activities supported by that influence, though difficult, is not impossible. But it will take fundamental reform of the political environment that has provided such a fertile habitat for organized interest groups. You don't overcome the alligators by fighting them one at a time; you do so by draining the swamp. And the reform necessary to drain the political swamp and rein in the power of the

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organized interest groups involves restoring true fiscal federalism, a restoration that can only be achieved by a dramatic decentralization in the power to tax.

I have in mind a return to a modified version of the fiscal arrangement contained in the Articles of Confederation in which all power to tax resided within the state governments, with the federal government relying on the states for the revenue to support its activities. The flaw in this arrangement was that each state faced the temptation to free ride on other states' contributions to the federal government. While this flaw dominates the general perception of the Articles of Confederation as unworkable, it is easily corrected. Rarely considered are the advantages realized when the power to tax is as decentralized as it was under the Articles of Confederation. These advantages include reducing the influence of special interests on political decisions, increasing the accountability of government at all levels, and motivating a more rational assignment of responsibility for government functions between the federal, state, and local levels of government.

To best appreciate the advantages of decentralizing the power to tax, consider first the persistent pressures toward greater political centralization.

The Politics of Centralization

The ideal of democracy may be the dispersion of power, but the tendency in democracies is the centralization of power; in politics centripetal forces dominate centrifugal forces. Governments in the major industrialized countries have, almost without exception, become more centralized during the twentieth century (see Vaubel 1992). The United States is no exception. In 1929 the federal government collected approximately one-third of all government receipts in the United States and accounted for slightly more than one-fourth of total government expenditures. Currently the federal government collects almost two-thirds of all government receipts in the United States and accounts for almost 70 percent of total government expenditures. As the federal share of government revenues and expenditures increased, so did the relative size of government in total. In 1929 total government spending was approximately 10 percent of national income. Currently total government spending is over one-third of national income.

One explanation for the increased centralization of government is that it is required for government to perform more efficiently. Supposedly, as problems become increasingly complicated and people become increasingly mobile, more of the services demanded of government generate benefits that extend beyond the boundaries of state

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and local governments. Education, public health, environmental protection, and poverty relief are commonly cited examples. State and local governments will fund such services below levels that are efficient since the constituency in each recognizes that (1) its contribution would be of little consequence, and (2) it can free ride on the contribution of others. The explanation is typically accompanied with the argument that the federal government, with its wider constituency, is in the best position to use its power to tax to insure the adequate supply of otherwise unprovided services by either supplying them directly or providing revenue to state and local governments for the purpose of supplying them. In other words, government becomes more centralized because it is efficient for it to do so (see Oates 1972).

This efficiency-enhancing explanation for government centralization would have credibility if government decisionmakers possessed the information and motivation necessary to determine and promote some common vision of the public interest. Although, if this benevolent view of government were made explicit, few would embrace it, it provides the implicit rationale for many public programs and policies. A more realistic model of government consists of political decisionmakers pursuing their private objectives subject to the constraints imposed by the political process. In this private-interest model of government, political outcomes are seen to emerge out of the interaction of diverse and competing interest groups. There is no presumption of efficiency in the private-interest model of government. Efficient outcomes may or may not emerge, depending on how well the political process matches up those who realize benefits from government services and those who pay for those services.[1]

Unfortunately, relatively small and well-organized interest groups commonly obtain benefits through political action that imposes costs on the general public in the form of higher taxes and a less efficient economy. The ability and motivation of such interest groups to take political action is seldom countered by those paying the bill because their numbers are so large and their individual stakes are so low. When considering an explanation for political centralization within the private-interest model of government, one has to examine how organized interest groups (those with the most to gain from political action) benefit from that centralization. For several reasons politically influential interest groups stand to benefit when the federal government's control over taxing, and therefore spending, is increased.

[1]The primary contribution of public choice economics has been to (1) force economists to explicitly recognize that benevolent despot models of government underlie most recommendations for public policy, and (2) provide another model of government that is consistent with the model economists use to analyse the private market.

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Consider a geographically concentrated interest group benefiting from government transfers and protections. Moving the source of these benefits from the local or state government to the federal government increases the size of the exploitable population. The larger the group paying for a special interest's benefits, the lower the per-capita cost of the resulting taxes and inefficiencies, the more difficult to organize the group around a common purpose, and therefore the less the political resistance to the special interest's demands. Even if members of an organized interest group are spread over many political jurisdictions, with centralizing control over their favored government program doing nothing to increase the exploitable population, centralization can still increase the interest group's political effectiveness. The per-capita cost of the group's existing program remains the same after centralization as before. But under federal control, the cost of a targeted expansion of the special-interest benefits received by those in any one part of the country is spread over a larger public, thereby reducing political opposition to such an expansion. Also, federal control reduces the political transaction costs faced by interest groups. It is easier to master control of a few centrally located special-interest levers than to deal with a multitude of such levers spread over different government levels and jurisdictions.

Politicians and government authorities at the state and local levels form influential interest groups which, one might think, would oppose increasing the political power of the federal government. But those whose interests are tied to state and local governments can realize genuine advantages from increased federal control over taxing and spending. Transferring control from state and local governments to the federal government can enhance the power, and increase the tax revenue, of all levels of government.

Consider the benefit to state and local governments when the federal government assumes more control over tax bases that have traditionally financed state and local expenditures. The larger the percentage of the total tax bill the central government imposes, the less significant the differences in state and local taxes to the overall tax burden of each taxpayer. The reduction in the tax advantage realized from locating in one political jurisdiction relative to another reduces the tax competition between those jurisdictions. In effect, increasing the power of the federal government to tax is a way of forming and enforcing a tax cartel, allowing the industry of government to charge more for its services (see McKenzie and Staaf 1978). The additional tax revenue can be allocated through revenue-sharing arrangements so that all government units end up securing more of the taxpayers' money. Under the formal revenue-sharing program that

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existed in the 1970s and into the early 1980s, the revenue-generating capacity of state and local governments was enhanced by formulas for revenue allocation that favored recipient governments which scored high on "tax effort"—i.e., continued to make good use of their own power to tax. Centralizing the power to tax increases the growth of government, a proposition that is supported by empirical evidence (see Martin and Schmidt 1983).

There is no mystery in the fact that federal officials can benefit from increasing the federal government's power to tax. Clearly those with a vested interest in expanding the agencies and programs of the federal government see advantage in more federal tax revenue. This advantage is not diminished by the fact that much of the revenue collected by the federal government is shared with state and local governments. The federal government can, and does, use the revenues it shares to buy political support for particular policies and incumbent politicians, and to induce state and local officials to provide services and demand programs that federal agencies help support and administer. By offering matching and categorical grants to state and local governments, the federal government produces a demand for federal involvement in a host of activities that should be the sole responsibility of local governments.

The greater the taxing power of the federal government, the more the political process rewards organized interest groups, and state and local governments, for demanding projects that are worth less than they cost, and the less it will reward them for implementing such projects efficiently. But regardless of the inefficiencies (and often because of them), it is in the interest of each organized group to demand more spending on its program and to push for the political centralization that amplifies that demand.

Improving on the Articles of Confederation

Returning to a governmental structure that accomplishes more while attempting less will require a clear and rational assignment of responsibilities between the different levels of government. Achieving this cannot be done by attempting to determine the details of what government should do and which levels of government should do it. The key to more responsible government is changing the political process so that it does a better job motivating political activity that promotes the interest of the general public. With the importance of political incentives in mind, I put forth my proposal for reverse revenue sharing. Although the proposal is consistent with the political traditions of federalism upon which the United States was founded, we have

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moved so far away from those traditions with the centralization of political power that reverse revenue sharing will now be seen as radical in the extreme. But a radical departure from the political status quo should appeal to those who want to be known as "agents of change," especially if there are compelling reasons for believing that the radical departure is a change for the better. And there are compelling reasons for believing that reverse revenue sharing would be a change for the better.

Under reverse revenue sharing, the federal government has no power to tax. All power to tax resides within the states. Such an arrangement harkens back to the fiscal federalism established by the Articles of Confederation which served as a compact among the states during the Revolutionary War (although it was not officially adopted until March 1781) and was replaced by the United States Constitution in 1789. Counter to almost universal opinion, the most serious problem under the Articles of Confederation was not the lack of an independent power to tax by the federal government. The real problem was that the states were under no legal obligation to share their tax revenue with the federal government. Without this obligation, each state faced a strong temptation to free ride on other states' contributions to federal activities that provided general benefits—such as carrying out the war against Britain. My reverse revenue sharing proposal eliminates this free-rider problem by requiring that each state share a proportion of the tax revenue it raises with the federal government, with the proportion being uniform over all states.

The Case for Reverse Revenue Sharing

By decentralizing the power to tax, reverse revenue sharing mitigates, if not eliminates, many problems caused by the existing, highly centralized, fiscal arrangement. Under reverse revenue sharing the political influence of organized interests would be reduced. If President Clinton is serious about controlling the special interests, he should be working to shift power out of Washington and back to the states, rather than pushing in the opposite direction. Under reverse revenue sharing the federal government would face strong incentives to confine its attention to truly national concerns. Pork-barrel projects would cease to be politically attractive. Reverse revenue sharing would motivate state and local governments to be more selective in the services they provide and more efficient in providing them. The privatization of government services would increase dramatically.

By confining taxing power to the states, and therefore concentrating the burden of any decision to increase taxes on fewer taxpayers, reverse

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revenue sharing would bring the political costs of spending proposals more in line with the social costs. Those who pay for government programs would have more motivation and ability to respond politically to the costs of those programs. But even at the state level, organized special interests can communicate the benefits received from spending programs better than taxpayers can communicate their costs. If each tax dollar raised by a state government could be spent on constituent groups within that state, the tendency for government to tax and spend beyond efficient levels would remain strong. This tendency is reduced by reverse revenue sharing since local taxpayers pay more than local interest groups receive, thereby increasing taxpayer motivation to oppose taxes relative to special-interest motivation to champion them. Indeed, reverse revenue sharing could make opposition to taxes the dominant political influence. In the extreme case, for example, with the state governments required to transfer 100 percent of the revenue raised to the federal government, organized interests within states would have no motivation to lobby for taxes on local constituents. This case is not recommended, of course, since it would result in all levels of government being underfunded by any reasonable criteria of efficiency.[2]

Next, consider the current incentives for the federal government to finance projects that are clearly local responsibilities. When state and local officials can obtain federal money, and recognize that the federal dollars they do not capture will be captured by others, local political advantage is in clamoring for federal financing of local projects that are commonly a waste of taxpayers' money and which, if they were not, would be financed locally in the absence of federal help. Consider just a few of the items that were strong candidates for federal funding under President Clinton's "stimulus" bill before it was derailed by a Republican filibuster. There was an indoor baseball field for Huntsville, Alabama, at a cost to the federal government of $1.08 million; a baseball and soccer park for Jonesboro, Arkansas, at a cost to the federal government of $5.3 million; three bike paths for Modesto, California, at a cost to the federal government of $1.3 million; expansion of the civic center in San Leandro, California, at a cost to the federal government of $12.8 million; a project to resurface tennis courts in Evanston, Illinois, at a cost to the federal government of $28 thousand; a movie theater in Columbus, Ohio, at a cost to the federal government of $2.7 million; research for a bike path in Eugene,

[2]Obviously the proportion of state tax revenue that has to be shared with the federal government can be either too small or too large from the perspective of economic efficiency. For a discussion of the efficient proportion, see Lee (1985).

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Oregon, at a cost to the federal government of $800 thousand; three swimming pools in Midland, Texas, at a cost to the federal government of $1.0 million; and the list goes on.[3] Reverse revenue sharing would put an end to such pork-barrel projects.

Under reverse revenue sharing the federal government would face a strong incentive not to finance projects that provide benefits primarily to state and local constituents. The financing of such projects by the federal government would undermine its only source of revenue by relieving state and local governments of the need to raise revenue. The federal government would finance only those services that improve the general well-being of the country and the general productivity of the economy, but which no state would finance unilaterally. Governors and mayors might remain anxious for federal funding of bicycle paths, tennis courts, and swimming pools, but they would soon learn that lobbying for such funding was futile, given the resistance of federal officials and the limits of the federal budget.

Reverse revenue sharing would also promote efficiency in government spending by enhancing political competition among the states. Differences in the taxing decisions of the various states would not be obscured by a heavy overlay of federal taxation. The state that increases taxes without increasing services commensurate with that increase would find its tax base being competed away by other states. Such competition would convert the ever-present temptation for state governments to free ride on the contributions of other states into a source of efficiency rather than inefficiency. With state governments currently receiving much of their revenue from the federal government, state authorities and their special-interest constituents can benefit as free riders by spending tax money on local projects and programs worth less than they cost. Under reverse revenue sharing, with the federal government limiting its expenditures to providing general benefits to all states, each state would recognize that its federal benefits would be largely independent of its contribution to federal revenues, with it difficult for the federal government to punish a state for reducing that contribution. With reverse revenue sharing a state could free ride by reducing its federal contribution, without reducing services to its citizens, only by providing those services more efficiently. It is hard to imagine a policy doing more than reverse revenue sharing to motivate the privatization of government services.

[3]These projects come from a larger list published in the editorial "Pork Carry-Out," *Wall Street Journal*, 5 April 1993. This list came from an even larger list of over 4,000 public works projects that are contained in the National Conference of Mayors "Ready to Go" projects that Housing and Urban Development Secretary Henry Cisneros said the Clinton adminstration would have worked from had the $16.2 billion "stimulus" bill passed.

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Make Governments Compete

The problems resulting from the centralization of power in the federal government, and which I have argued would be mitigated by reverse revenue sharing, have been recognized at high levels within the Clinton administration. Alice Rivlin, director of the Office of Management and Budget, argues in a recent book that the United States "cannot afford a cumbersome national government, overlapping responsibilities between the federal government and the states, and confusion over which level is in charge of specific domestic government functions" (Rivlin 1992: 30). According to Rivlin, "Washington not only has too much to do, it has taken on domestic responsibilities that would be handled better by the states" (31).

But while Rivlin sees some of the same problems with political centralization that motivates this paper, she stops well short of advocating the degree of decentralization represented by reverse revenue sharing. She sees a major problem for the states in obtaining the revenue to assume greater responsibilities because "states compete with each other" (127). Rivlin's menu of collusive arrangements for overcoming the inconveniences of this competition include—as the "most straightforward and practical" arrangement (148)—a federal tax which would be distributed to the states, and a compact of the states in which they agree "to levy and share a common tax" (149). By rejecting competition among governments, Rivlin, along with most economists (and noneconomists) implicitly buys into the view of government as a benevolent promoter of efficiency. Economists who immediately cry monopoly and call for antitrust action at the slightest evidence of increased industrial concentration applaud collusive arrangements that reduce competition between government jurisdictions. Rather than recognizing that competition is necessary to provide the information and motivation for efficiency in political activity, as in market activity, most people see competition as a constraint on government's ability to promote the public interest.

The centralization of government power that would be maintained, if not increased, by Rivlin's recommendation to limit competition among governments, would insure that her recommendation for shifting more domestic responsibilities to the states would be ignored. Government responsibilities will be assigned appropriately only in response to the pressures of a competitive process that gives those who are paying for government services more power to determine which services are provided and which government jurisdictions provide them. The case for reverse revenue sharing is that it would go a long way in creating such a competitive process.

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It is true that under the competitive pressures imposed by reverse revenue sharing, some "essential" government services will be scaled back or eliminated. Any time an interest group receives benefits from expenditures that are being financed by others, one can expect those expenditures to be considered essential by the interest group. By improving the connection between those who pay for government services and those who benefit from them, reverse revenue sharing would render many government expenditures a lot less essential than they are under current arrangements. By reducing spending on government activities that cost more than they are worth, reverse revenue sharing may also reduce genuinely worthwhile government spending. Imposing accountability on spending decisions always risks passing up some desirable spending, but this is a reasonable price to pay for reducing the level of irresponsibility that characterizes so much current government spending. Also, currently worthwhile government services are not provided, or provided poorly, because they are crowded out by an avalanche of special-interest spending, or provided in the absence of competitive pressures.

Conclusion

With the proliferation of federal bureaucracies, programs, projects, and policy experts throughout the country, the federal government has become less capable of being controlled by the governed and, therefore, less capable of properly governing. The case is strong for downsizing the federal government, focusing its attention on truly national and international concerns, with government responsibility for most domestic concerns being shifted to the state and local levels. The popularity of such a shift is reflected in the ubiquitous campaign promises to return government to the people. But the political process, as currently instituted, is more responsive to narrowly focused groups than to the general public. And narrowly focused groups typically see their interests served best when political authority is exercised by the federal government.

So despite the bipartisan rhetoric in Washington in favor of getting government closer to the people, any serious proposal for doing so would be considered extremely undersirable by the politically influential. Certainly reverse revenue sharing would meet with powerful opposition if it began to be considered seriously. Precisely because reverse revenue sharing would be such a force for increased government efficiency—reducing the political influence of organized interest groups—it will fail to attract organized political support. Indeed, few things would provide more compelling evidence against reverse

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revenue sharing than the formation of a coalition of organized special interests in favor of it. I have confidence that the case for reverse revenue sharing is safe from this damaging prospect.

To acknowledge that a return to the fiscal federalism represented by reverse revenue sharing will not occur in response to special-interest pressures is not to dismiss the possibility of such a return. Significant political reforms are seldom, if ever, driven by the thrust of ordinary politics. But when it is widely believed that the political process is malfunctioning, and politics as usual has consistently frustrated hope for improvement, the combination of aggravated citizens, nervous politicians, and some precipitating event, or series of events, can lead to fundamental political reform. As the likelihood of such reform increases, so do the advantages of promoting discussion on reforms that hold promise for genuine improvement in the political process. With this in mind I put forth my proposal for reverse revenue sharing.

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Cable Reregulation

Donald J. Boudreaux and Robert B. Ekelund, Jr.

Congress enacted the "Cable Television Consumer Protection and Competition Act of 1992" over the veto of President George Bush.[1] This act purports "to provide increased consumer protection and to promote increased competition in the cable television and related markets." We here analyze some important economic implications of the act. Our analysis of cable-television history (especially the brief period of deregulation, 1984–92) and of the contents and amendments of the new act indicate that the achievement of public-interest goals is most unlikely. The Cable Act of 1992 admits self-interested outsiders (mainly, broadcasters in competition with cable operators, along with municipal tax collectors) to the profits generated by the supply of cable TV services. Further, the act will redistribute the profits of local cable companies by changing property-rights assignments *without* fostering new competition. Whether the nominal price of some homogeneous unit of cable services rises or falls, we argue that service quality (including the introduction of new technologies and products) will decline over time.

Following a review of the period of cable deregulation, this article treats two major aspects of the 1992 Cable Act. These are (1) the reinstitution of rate regulation at the municipal level of government

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[1]This act (P.L. 10–385) is codified at 47 U.S.C., Sections 521-609.

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under the aegis of the Federal Communication Commission (FCC),[2] and (2) the restrictions imposed on ownership forms and on the ability of cable operators to choose which programs to carry. While other aspects of the act are important, a study of these two issues is central to the economic consequences of cable reregulation.

Deregulation of the Cable Industry, 1984–92

Several regulatory regimes have existed over the brief history of cable television in the United States (Posner 1972, Williamson 1976). A consensus between over-the-air broadcasters, the cable industry, and other interested parties was reached in 1972 under President Richard Nixon. This consensus set rules regulating the new and increasing cable competition facing broadcasters (Besen 1974). The goal then was to protect markets of the television networks and local broadcasters. Part of this protection included cable rate regulation by municipalities (overseen by the FCC).

The most recent regulatory regime prior to the Cable Act of 1992 was inaugurated by the Cable Communication Policy Act of 1984. The 1984 act freed cable operators from rate regulation provided that communities were supplied cable service under "effectively competitive" conditions. (Rate deregulation took effect in December 1986, with other parts of the deregulation beginning in 1984.) Rate deregulation—essentially the lifting of rate regulation by city governments—had a clear impact on important dimensions of the cable industry. The impact of deregulation on prices, technology, and programming will be considered first. We then investigate the important relation between the interests of municipal governments and competition in the cable industry.

Prices, Deregulation, and Product Quality

The most strident criticisms of the cable industry have been aimed at the supposedly unwarranted price increases that occurred during deregulation. Changes in monthly rates for basic cable services between 1986 and 1991 were calculated by the U. S. General Accounting Office (GAO 1990a, 1990b, 1991). The price of the most popular tier of basic rate service increased from $11.71 per month in November 1986 to $18.84 in April of 1991, an increase of 61 percent.

[2]Since the enactment of the act, the FCC has issued two separate orders mandating that cable operators lower their rates. The first order, issued in April 1993, required a 10 percent rate reduction; the second order, issued in February 1994, demanded that rates be lowered by 7 percent.

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The period of deregulation (1984–92) coincided with rapid growth in cable-industry investments in programming and technology. Deregulation stimulated investment in programming by basic cable networks (such as CNN, TBS, and CNBC) and premium networks (such as Disney, HBO, and Showtime). Such spending more than doubled between 1984 and 1990. A sizable portion of this programming included new and innovative cable networks providing better television to ever more numerous markets. For example, cable television now includes quality children's programming on Nickelodeon, around-the-clock sports on ESPN, original documentaries on the Discovery Channel, gavel-to-gavel coverage of U.S. Congressional activity on C-SPAN, and both Hispanic and Black Entertainment Television. Beyond these developments, several dozen multiple system operators (MSOs) and cable-program services have launched the Cable Alliance for Education, providing hook-ups and basic cable service to all junior and senior high schools passed by cable systems. *Cable in the Classroom* offers free use of 20 different cable networks providing a diversity of classes in math, English, science, social studies, biology, foreign languages, health, vocational, and technical studies.

In short, there is evidence—admittedly anecdotal—of rapid technological development during the short period of deregulation. Increased plant and equipment investments resulted in a rise in the percentage of cable systems offering more than 30 channels between 1984 and 1992. Between 1984 and 1990 that percentage grew from 38 to 67 percent, with the cable industry planning to spend nearly $17 billion more in the 1990s to improve plant and equipment. Most of these expenditures, if realized, will be used to deploy fiber-optic technology and to enlarge cable's existing broadband network.[3]

[3]Cable investments are concentrated in Cable Labs, an industry research and development consortium. This consortium tests high-definition television, interactive services, and a number of other new technologies. Technological developments created within the cable industry—specifically, a marriage of the coaxial cable and fiber-optic technologies—are currently being brought to fruition in selected markets. For example, on December 18, 1991, Time-Warner launched the world's first 150-channel cable television system in Queens, New York. The service, called *Quantum*, adds 75 channels to existing systems at a total monthly rate of $23.95. The *Quantum* system includes 57 channels dedicated to pay-per-view distribution and promotion, with on-screen ordering of movies and events. Sixteen separate movie titles are available at all times with five newly released major hit films and the balance chosen to appeal to the widest possible variety of cable viewers' interests (movies are priced between $1.95 and $4.95). A variety of other new program services are available on *Quantum* and include the Monitor Channel, Nostalgia Television, NASA Network, Vision Interfaith Satellite Network, Mind Extension University, International Channel and Scola. Other channels have been set aside for experimentation on interactivity and additional cable services to the home. Grocery and other kinds of interactive shopping will soon be feasible using a cable channel. Eventually the system might handle high-definition television, voice interactivity, and linkages with computers, fax machines, and

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Municipal Misuses of Regulation

A critical feature of cable regulation throughout its history, and of the 1992 Cable Act, is the relation between local cable companies and the municipal governments exercising jurisdiction over service areas. Under current law, local franchising authorities (usually city councils) impose franchise fees of up to five percent of gross revenues, set basic cable rates where there is no "effective competition" (as defined by the FCC), determine the number of cable franchises to award in their area, determine channel "set asides" for public, educational and governmental-access stations, and establish customer-service requirements. The franchisor-municipality has the authority to appropriate still other monetary as well as non-monetary benefits from the franchised cable operator (Zupan 1989).[4]

The assigned locus of rate and franchise regulation—municipal governments—and the powers assigned go far in explaining the regulatory problem. Instead of curing actual or perceived problems in cable markets, municipal regulation causes many of these problems. The lack of expertise of city councils in the process of developing and granting complex franchise contracts and in conducting complicated rate hearings is one sound reason for opposing rate regulation at the local level. In addition, city councils are political bodies that will, under reelection pressures and other political constraints, attempt to redistribute wealth in a self-interested fashion. Consequently, cable rates may be politically suppressed, franchises may be granted for reasons having nothing to do with consumer welfare, and cable operators may be protected from competition in order to maximize the sums municipalities extract from these firms.

Whether cable supply at the local level is efficient or not depends upon municipal-governments' propensities to promote or to stifle competition. Thomas Hazlett (1990a), in a review of cable-industry litigation, found that municipalities intentionally impede competition and consistently demonstrate anti-consumer intent by trying to protect cable monopolists.[5] During the deregulatory period and before, municipalities had no obligation to promote competition in cable supply; that is, franchising authorities were not compelled to grant multiple ("overlapping") franchises. While some observers justify exclusive

personal communications networks (PCNs).

[4]For example, a cable operator in Sacramento, California was required to plant 20,000 trees (Varley 1986: 36). In Miami the cable operator had to agree to provide $200,000 annually for a police department anti-drug-abuse campaign in order to receive the franchise.

[5]Hazlett (1991) convincingly illustrates and expands this view in a study of the regulatory experience in California between 1981 and 1985.

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cable franchising by using a natural-monopoly argument, there is no hard evidence demonstrating that such conditions apply, in any relevant degree, to local cable supply. In fact, there is a good deal of evidence to the contrary (Owen and Greenhalgh 1986).

Municipalities' resistance to granting multiple franchises is better explained by the gains local politicians extract for themselves from aspiring cable monopolists. Between 1980 and 1990 the cable industry paid local governments $3.3 billion in franchise fees, with local fee revenues growing rapidly in the late 1980s ($715 million in 1990 alone). While viable local competition for the supply of programming has evolved gradually (chiefly from satellite suppliers) and will likely accelerate due to fiber optics and other new technologies, municipal governments continue steadfastly to reject overlapping competition from multiple cable operators.[6] Wealth is more easily collected from a single operator, while revenues (and, hence, municipal tax receipts) are also likely to be higher if the cable operator is a protected monopolist than if it faces competition from other cable operators.[7]

Municipal governments typically promote monopoly supply of cable services despite the fact that virtually all well-executed empirical studies of competition in the cable industry find significant welfare benefits to consumers from overlapping municipal cable supply (Merline 1990; Levin and Meisel 1991; Beil, et al. 1993). Because politicians' objective functions include in-kind transfers, higher reelection prospects, etc., as well as revenues, it is not surprising to find that municipalities were among the chief advocates of cable reregulation: rate regulation also serves as an important tool for achieving politically motivated wealth redistributions between cable operators, consumers, voters, politician-franchisors, and the municipal fisc. Hazlett (1991: 294) argues that "price controls are important institutional tools for regulators. . . Rate regulation allows franchising authorities to remain 'in the loop,' exercising some level of control over monopoly rents which they have created and assigned."[8]

The Cable Act of 1992 reimposes rate re-regulation and significantly broadens ownership restrictions. What will be the effect of these new cable regulations? To answer this question, the tradeoffs between the

[6]By 1989 only 55 communities were served by overlapping and competing cable firms (see Kagan et al. 1989, 1990).

[7]Webb (1983), Zupan (1989), Mayo and Otsuka (1991), Beil, et al. (1993), and Ford and Jackson (1993) all provide empirical evidence that cable systems operate in the inelastic region of demand. Falling cable-operator revenues resulting from the recent FCC rollback of basic cable rates support these findings (see McAvoy 1994, and Stern 1994).

[8]The process of rent transfers through local franchising arrangements is described in Ekelund and Saba (1981).

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price and the quality of goods such as cable service must be clearly understood.

The Effects of Rate Reregulation on Cable Quality

The price consumers pay for a good or service is only one of many terms of the contract between consumers and suppliers. In exchange for a certain price per unit of good or service sold, a supplier agrees to supply various quality attributes and services to consumers.[9] Although consumers always prefer to pay as little as possible for any *given* package of goods or services, it is equally true that few quality attributes of goods or services are fixed and unchanging. Consequently, because price reductions can cause the quality of a good or service to fall, it is wrong to believe that consumers typically are made better off by government-mandated price reductions.

The lesson here is elementary and uncomplicated, yet nevertheless vital in light of the fact that it is ignored by those who applaud cable rate reregulation. We first develop a simple model to show that rate regulation will likely make consumers worse off. Application of this model to the cable-television industry is then quite straightforward.

Consider Figure 1. Pecuniary price is on the horizontal axis, and product quality is on the vertical axis.[10] Each *U*-curve depicts alternative combinations of price and product quality that yield for consumers the same level of utility. Although indifferent to where they are on a given curve, consumers are not indifferent to which curve they are on: *U*-curves further to the left represent higher levels of consumer satisfaction; *U*-curves further to the right represent lower levels of satisfaction.

Each curve labelled π depicts alternative combinations of price and product quality that yield the same rate of return for producers. Producer profits increase as producers move from π-curves further to the left to π-curves further to the right. π^n represents normal

[9]Some attributes of product quality are supplied according to explicit agreement between buyer and seller (e.g., a car-dealer's agreement to give a buyer a free loaner car whenever the buyer's own car is in the shop overnight for repairs). Other attributes of product quality are implicit in the sales contract. Sales contracts with no explicit warranties are enforced under section 2-314 of the Uniform Commercial Code as containing a warranty of implied merchantability.

[10]Product quality has a multitude of specific features. For cable television, quality includes such obvious features as reliability of service (i.e., few service interruptions), program selection, clarity of video and audio reception, and availability of up-to-date remote-control technology. In addition, quality includes less obvious things such as friendliness of cable-company personnel and responsiveness to customer complaints. We compress all of these features of product quality into a single aggregate measure in order to make it tractable in a two-dimensional graph.

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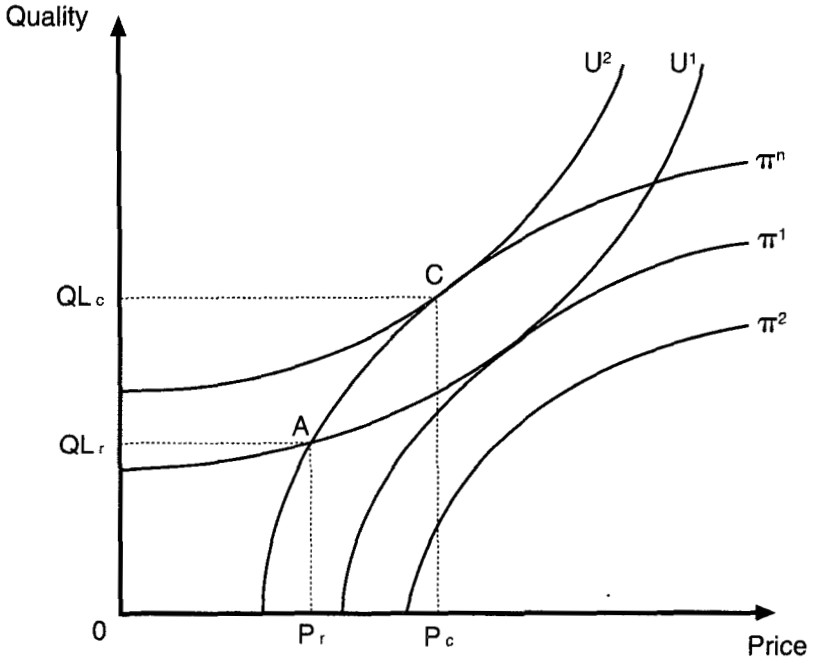
FIGURE 1

QUALITY CHANGES IN AN INTERACTIVE SYSTEM



profits; because no producer earning less than normal profits will continue operating in the long-run, no price-quality combination to the left of π^n is sustainable.

Figure 1 shows that, in equilibrium, unregulated producers will always offer that combination of price and quality that exists at the point of tangency between a π-curve and a *U*-curve. This is true for monopolists no less so than for competitive suppliers (although the equilibrium rate of profit for monopolists will typically be higher than that of competitive firms).

If a firm in a competitive industry earns above-normal profits, rivalrous responses by competitors will drive this firm's profits down to normal. Thus, competition continually presses prices toward the normal-profit curve. In addition to the pressure applied by competition to keep prices low, the quest for profits by competitive firms also prompts firms to improve quality. A producer who offers a quality improvement that consumers find attractive is able to charge a higher price and, hence, earn above-normal profits for a time. But competition from rivals who imitate this quality change will eventually push the price down to the normal-profit level. Such quality improvements will continue so long as consumers value these improvements by at least

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as much as the increase in price necessary to give producers the incentive to make these improvements.

In Figure 1, the competitive equilibrium is at point C, with price P_c and quality QL_c. Given the prevailing costs and demand conditions, consumer welfare can be no higher than that which is represented by the indifference curve U^2. Any combination of price and quality other than P_c, QL_c is either to the left of π^n (and, hence, not sustainable in the long run), or is on a consumer indifference curve yielding lower consumer welfare than U^2. Suppose, for example, that the current combination of price and quality is P_r, QL_r (shown at point A in Figure 1). Although firms are making normal profits, consumer welfare is not maximized with this particular combination of price and quality. Producers who improve quality will for a time be able to sell this higher-quality offering for a price higher than P_r. The quest for profits by producers will thus push quality up from QL_r to QL_c; rivalry among producers will ensure that in the long run no producer earns more than normal profits (i.e., producers supplying a level of quality QL_c will be able to charge no price higher than P_c).

It is now easy to see the effects of a government-mandated reduction in price. If firms are competitive, any such price reduction *not* accompanied by a corresponding reduction in quality causes firms in this industry to shut down. Realistically, however, firms have the more attractive option of lowering their product quality until their costs are reduced enough to enable these firms to earn at least normal profits at the regulated price.

In Figure 1, this process begins with regulators forcing prices down from P_c to P_r. Prohibited by law from charging prices higher than P_r, firms thus reduce product quality from QL_c to QL_r. Given this price regulation, the industry is in equilibrium at point A. In the long run, firms are no worse off at point A than at point C. Consumers, however, are indeed worse off. Before the mandated price reduction, consumers enjoyed an amount of utility shown on curve U^2, but with this regulation, consumer utility is reduced to U^1. Lower prices are not an unambiguous boon to consumers as long as product quality is a variable.

What is true for competitive suppliers is true in this case for monopolistic suppliers as well: Price regulation of monopolistic suppliers will sponsor quality changes that diminish consumer welfare. Even monopolists have incentives to make their product offerings attractive to consumers. A monopolist's profits, as well as consumer welfare, are enhanced by the monopolist's expenditures on product-quality improvements that cause revenues (via increased consumer demand) to rise by more than the costs of the improvements. Although a

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monopolized industry may not provide as much quality as a competitive one, even the most entrenched monopolist has some incentive to provide quality products and service to its customers. Therefore, any forced reduction in price by government will inevitably lead to deterioration of product quality, even when the industry is monopolized. The monopolist will respond to a mandated price reduction by lowering product quality in an attempt to maintain its profits. The general lesson is that price regulation will inevitably lead to product-quality deterioration. Consumers suffer as a consequence.

Enthusiasts for government regulation might insist that a solution to the problem of reduced product quality is further regulation decreeing that suppliers not diminish product quality. But such an argument rests on a fantastic belief—namely, that government regulators can know and observe every facet of product quality that is relevant to consumers. Because in reality product quality exists simultaneously in hundreds, perhaps thousands, of different dimensions, it is impossible for even the most well-intentioned and sage regulator to garner the knowledge necessary to ensure against deterioration in product quality.

Thus, because regulation of every aspect of product quality is a practical impossibility, regulation that effectively forces cable rates down—such as is achieved by the Cable Act of 1992—will almost surely generate quality reductions that harm cable subscribers. Cable operators will respond to mandated lower rates by offering less-abundant selections of channels, lower-quality equipment, and less-responsive customer service. Suppliers may also reduce investments in quality control and in improvements of their capital stock. These are only some of the innumerable routes cable operators can choose in order to maintain their profits while simultaneously charging the lower rates imposed by regulators.

There is some (admittedly anecdotal) evidence concerning the price-quality tradeoff from the period of cable deregulation. Basic cable penetration increased significantly over the period of deregulation. During the six years prior to deregulation, the number of homes passed by cable systems—the number of *potential* subscribers to cable—doubled from 34.9 million in 1980 to 69.4 million in 1986. But cable penetration—the percentage of homes passed that actually *subscribed* to cable—increased by only four percent, from 55.0 percent to 57.2 percent. In fact, in the *three* years prior to deregulation, penetration increased by only 1.8 percent. In the first three years *after* deregulation, in contrast, basic penetration increased by approximately 7 percent. By 1991, penetration exceeded 61 percent of the homes passed by cable systems.

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Increased cable penetration over this period of deregulation is consistent with the fact that rate deregulation was accompanied by product improvements making cable services, even at higher prices, more attractive to consumers. Increased penetration is consistent with the fact that cable operators improved quality in the kind of price-quality interplay described in the theory outlined above. Although evidence of increased penetration hardly proves that cable rates became perfectly competitive during the deregulatory period, it does suggest that deregulated rates were closer to competitive levels than were rates allowed by municipal price regulators. As argued above, all companies—whether operating under competitive or monopolistic conditions—will choose to improve their products if consumers are willing to pay for such improvements.

Municipal rate regulation appears to have hurt consumers by preventing cable operators from raising rates and by limiting the kind of innovative expenditures that they made after deregulation. Under the 1992 Cable Act, municipal governments or the FCC will once again suppress rates to levels that make consumers worse off than they were under deregulation.

Of course, not every consumer is better off with higher rates and improved service, but more consumers to whom cable is available find cable to be worth the price. While penetration increased between 1984 and 1992, some subscribers may have canceled their service because they either could not afford the improved service at a higher price or because they did not think the expanded service at the increased price to be a good value. Those particular subscribers would be better off if rates and quality of service were suppressed by regulation. Consumers as a group, though, appear to have reaped substantial benefits from cable deregulation.

Policymakers may be legitimately concerned about rate increases and quality improvements that eliminate lower-income consumers from the market. But this is a problem of distributional equity that exists whether or not higher cable rates reflect competitive or monopolistic pricing. Specific remedies (e.g., consumer subsidies) to address the problem of consumers who cannot afford cable and cannot receive a sufficient number of free television stations over the air are more appropriate than rate regulation. A solution that suppresses the price and, thus, the quality of cable service reduces overall consumer welfare.

Property Rights Restrictions

In addition to strengthening the ability of local franchising authorities to regulate cable rates, the 1992 act imposes inefficient carriage

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requirements on cable operators. The act also unwisely restricts ownership possibilities of cable operators and of video programmers. We discuss two of the more important property-rights restrictions contained in the 1992 act.

Carriage Requirements

Section 4 of the 1992 act requires cable operators to carry in their most basic tier of channel selection the signals of local commercial television stations as well as the signals of qualified low-power stations. Section 5 requires each cable operator to carry the signals of all qualified local noncommercial educational television stations.

These requirements are, at best, redundant and, most likely, harmful to consumers. First, because a cable operator must carry a local network affiliate "whose city of license reference point . . . is closest to the principal headend of the cable system" (Sec. 4(b)(2)(B)), each local network affiliate is protected artificially from the competition of network affiliates elsewhere.

Second, local cable operators—be they monopolists or not —have strong incentives in the absence of government regulation to carry the particular mix of programming that maximizes consumer satisfaction. Thus, Congress need enact no statute, and the FCC need promulgate no regulation, prescribing cable-operator programming in the name of consumer welfare. If a cable-operator's subscribers are willing to pay higher rates (or if homes passed by cable are more willing to subscribe) when the cable operator offers a program package containing stations A, B, and C than when it does not offer these stations, the cable operator will carry these stations without any prompting from government. This is true regardless of whether stations A, B, and C originate locally or nonlocally, or whether they feature all, some, or no educational programming.

Consequently, stations have incentives to maximize the appeal of their programming in order to be carried by as many cable operators as possible. Stations that do relatively poor jobs of providing interesting and appealing programming (as defined by the tastes of cable subscribers and potential subscribers) will be carried by fewer cable operators than will stations that provide more appealing programming. Because of the ability of cable operators to gain access (via satellite) to the signals of broadcasters from distant regions, it is no exaggeration to say that competition among television stations takes place potentially on a nationwide basis. Broadcasters now have the technical ability to compete not only with the small handful of other broadcasters in each of their local vicinities, but with broadcasters located across the country. If, for example, the local New Orleans affiliate of NBC offers

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a programming mix that is more appealing to residents of Houston than is the mix offered by NBC's Houston affiliate, the cable operator in Houston can (if law allows) replace the local Houston affiliate with the New Orleans affiliate. Residents of Houston would be better off, and the profits of the Houston cable operator would be higher because of greater subscriptions and, possibly, higher rates. Such competition for cable carriage would heighten the sensitivity of television stations and other video programmers to viewer demands.

Of course, because residents of a particular city or county typically have high demands for local news and information, local stations are generally better able to meet such demands than are regional or national broadcasters or local broadcasters from other cities or towns. But the conclusion to draw from this fact is not that local stations deserve special legislative protection for their markets. Rather, the appropriate conclusion is that, because of the natural advantage in local markets enjoyed by local stations over stations originating elsewhere, only local stations that are especially inept at devising programming to meet viewer demands are in need of such protection. There is no good reason to erect statutory barriers shielding local stations from the competition of distant stations. Nevertheless, such shielding is just what section 4 of the act does.

Likewise, cable subscribers as a group plausibly have demands for educational programming sufficient to prompt each cable operator to carry at least one station specializing in this type of programming. Section 5's requirement that cable operators carry one or more "qualified local noncommercial educational television stations" is at best unnecessary and, likely, harmful to consumers. This requirement is unnecessary because cable operators would typically carry a sufficient number of educational channels even in the absence of this regulatory requirement; it is harmful when it forces operators to carry a greater number of educational channels than their subscribers want.

Because cable operators have incentives to carry the mix of programming that maximizes consumer welfare, the carriage requirements of Sections 4 and 5 of the act can, if they have any effect, only lead to suboptimal mixes of station offerings. The act will cause a crowding out of stations that cable viewers prefer in favor of stations that are less preferred but whose carriage is required by law. Cable viewers will be harmed.

Ownership Restrictions

Section 11 of the act restricts available modes of ownership and control of cable operators and video programmers. These restrictions affect both horizontal and vertical ownership interests. In particular,

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the horizontal restraint in the act requires the FCC to issue regulations restricting the size of cable operators as well as the number of cable operators that can be lawfully owned by a single person or firm. Vertical regulations empower the FCC to restrict cable operators from owning interests in video programmers. Further, these new regulations severely limit the ability of cable operators to carry programming produced by video programmers with which cable operators are affiliated.

Horizontal Restrictions. On its face, empowering the FCC to police against untoward aggregations of monopoly power in the cable industry seems laudable. Unfortunately, though, this provision of the act will not promote consumer welfare. Restricting the number of subscribers to a particular cable system risks sacrifice of possible economies of scale in the distribution of video programming over cable without significantly increasing competition among cable operators.

Because cable operators have a high proportion of fixed to variable inputs, the average cost of serving each subscriber falls as more and more subscribers are added to a particular cable system. Given the notorious difficulty of estimating the cost-minimizing level of output by any means other than actual experimentation by firms in the industry (McGee 1974), there is a substantial risk that the FCC will restrict too severely the number of homes any particular cable operator is allowed to reach. Efficiency advantages of economies of scale are thereby threatened.

The counterargument supporting these horizontal restrictions is that they are necessary to protect cable consumers from monopoly exploitation. But this counterargument ignores the fact that, with few exceptions, most cable operators enjoy exclusive grants of monopoly privilege from local franchising authorities.[11] Failure to allow competitive overlapping cable systems is the primary source of monopoly power in the cable industry, not economies of scale or large size of cable operators. When a franchising authority grants a monopoly to a cable operator, that operator will invest in the efficient scale of plant given its likely market as defined by the politics of the franchise agreement. And the rates charged by this monopoly cable operator will be determined either by consumer demand in the politically defined franchise area (if the operator is unregulated) or by regulators as provided under the Cable Act of 1992. In either case, no benefits flow from restricting the number of customers a particular cable

[11]The number of franchise areas served by genuinely competitive cable operators is quite a small proportion of the total number of franchise areas—currently less than one percent of the approximately 10,000 total operators.

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operator may serve. Monopoly will remain a problem unless and until the practice of exclusive cable franchising is eliminated. Regulating the number of consumers able to be served by a particular cable operator does not promote consumer welfare, especially as long as exclusive franchising remains the general practice.

Although the 1992 act seemingly takes steps to eliminate exclusive franchising, effectively it does not do so. Section 7 mandates that franchising authorities "not unreasonably refuse to award an additional competitive franchise." Regrettably, Congress extracted the teeth from the provision by limiting the liability franchising authorities face as a consequence of granting exclusive franchises. According to the act, plaintiffs who successfully sue a franchising authority regarding "regulation of cable service or . . . approval or disapproval with respect to a grant, renewal, transfer, or amendment of a franchise" are entitled only to injunctive or declaratory relief. Suits for damages are prohibited by Section 24(a) of the act. Thus, the act's apparent insistence on competition in cable provision rings hollow.[12]

A plaintiff who wins the legal right to distribute cable in a particular locale has only the beginnings of a genuine victory. Details of the franchise agreement remain to be worked out before the plaintiff cable operator can begin operation. A franchising authority wishing to protect the monopoly position of an incumbent cable operator can impose a host of conditions, regulations, and fees on the aspiring cable competitor that will delay indefinitely the entry of this competitor into the market. In the absence of damage suits, the only way courts can realistically guard against such obstructionist tactics by franchising authorities is to engage in detailed oversight of these authorities' behavior. Understandably, courts will not enthusiastically embrace such tasks.

Vertical Restrictions. Section 11 of the act requires the FCC to conduct a proceeding "to prescribe rules and regulations establishing reasonable limits on the number of channels on a cable system that

[12]If Congress were truly interested in promoting competition in the video-distribution industry, it would have overturned the FCC's ban (in place since 1970) on cross ownership that makes it illegal for local telephone companies to operate cable-television systems within their service areas. The fiber-optic technology used by telephone companies gives these firms sufficient band width to deliver into homes not only traditional telephone services, but video-entertainment services as well. Telephone companies are obvious competitors of cable operators. Unfortunately, the 1992 act does nothing to open video-distribution markets to competition from phone companies. For a discussion of the feasibility and desirability of competition between telephone companies and cable operators, see Hazlett (1990b). Hazlett (1992) also argues that the reasons given twenty years ago for why competition between telephone companies and cable operators would be unworkable are no longer viable.

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can be occupied by a video programmer in which a cable operator has an attributable interest." In prescribing these rules, Congress commands the FCC to ensure that cable operators affiliated with video programmers give no special favors to their affiliated programmers when selecting the programs to carry on their cable systems. Congress is concerned that video programmers unaffiliated with cable operators will suffer undue difficulty finding outlets for their programming if cable operators own interests in competing programmers. Congress is also worried that cable-affiliated programmers will withhold their programming from unaffiliated cable operators [see Sec. 2(a)(5) of the act].

Neither concern is valid. The particular mode of ownership of the various stages of distribution of video programming in no way biases cable operators when they choose which programs or stations to carry; nor does the mode of ownership bias programmers to give undue favor to cable operators with whom programmers are affiliated. But such vertical restrictions on cable-operator ownership of programming are potentially harmful to viewers.

Consider how a hypothetical cable operator in Charleston, South Carolina (call it "Charleston Cable") decides which stations to carry. Suppose Charleston Cable is unaffiliated with any video programmer and has an activated band width of 30 channels. Charleston Cable has dozens of programmers/stations from which to choose to occupy its 30 available cable bands. It will carry the mix of 30 stations that maximizes its profits. Suppose that 29 of the 30 available bands are already committed, and that Charleston Cable is deciding whether to put TBS or WGN in the 30th band space. If WGN will add $5,000 per month to Charleston Cable's profits and TBS will add $4,000, Charleston Cable will carry WGN.

Charleston Cable's carriage of WGN provides more consumer satisfaction than carriage of TBS. The reason WGN earns more money for this cable operator than that added by TBS can only be because carriage of WGN improves Charleston Cable's ability to sign up additional subscribers and, absent rate regulation, strengthens its ability to charge higher monthly rates to subscribers. Unaffiliated cable operators undoubtedly have strong incentives to carry the mix of stations that best meets their customers' demands.

Importantly, the situation does not differ if Charleston Cable is owned by a video programmer—say, Turner Broadcasting Co., the owner of TBS. Charleston Cable will still carry WGN in lieu of TBS as long as WGN contributes more to Charleston Cable's profits than does TBS. As a profit-maximizer, Turner Broadcaster—the (now-assumed) parent of Charleston Cable—will not sacrifice the extra

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thousand dollars per month in Charleston Cable's profits that would result if Turner Broadcasting forced Charleston Cable to carry TBS rather than WGN.

It might be argued that this analysis overlooks the addition to Turner Broadcasting Co.'s advertising profits that result from TBS's carriage in Charleston. That is, even though Charleston Cable's profits would be $1,000 lower by carrying TBS instead of WGN, Turner Broadcasting might earn, say, $1,500 of extra profit from advertising revenue by having TBS broadcast in Charleston. In this scenario, Turner Broadcasting earns $500 more per month by forcing Charleston Cable to carry TBS than by allowing its cable subsidiary to carry WGN.[13] The apparent conclusion is that Charleston Cable will more likely carry TBS if Turner Broadcasting Co. owns Charleston Cable than if Charleston Cable is unaffiliated. More generally, it appears as if vertical integration of video programmers and cable operators affects which stations are carried over cable systems.

But this conclusion is faulty. It overlooks the fact that if Turner Broadcasting Co. could earn an additional monthly profit of $1,500 in advertising revenue by having TBS carried on the Charleston cable system, TBS would be carried on this system even if Turner Broadcasting Co. owns no interest in Charleston Cable. Suppose again that carriage of TBS by an unaffiliated Charleston Cable yields $4,000 net monthly profits for Charleston Cable from its subscribers while carriage of WGN yields $5,000. Also, continue to assume that Turner Broadcasting Co. would earn $1,500 in additional monthly profits from advertising sales if TBS were carried on the Charleston cable. Under these circumstances, Turner Broadcasting Co. is willing to pay up to $1,500 monthly to have TBS carried by Charleston Cable, and Charleston Cable will agree to carry TBS in exchange for some monthly payment by Turner Broadcasting Co. of $1,000 or more. Thus, as when Turner Broadcasting Co. owns the Charleston cable operator, an independently owned Charleston Cable will carry TBS.

The general lesson is that affiliation of cable operators with video programmers does not create an inefficient bias on the part of cable operators to carry programs produced by their affiliated video programmers. Moreover, as is well known in the economics literature, monopoly power possessed by a firm at one stage in the production

[13]Turner Broadcasting Co., through its subsidiary Charleston Cable, earns $5,000 per month in profits by carrying WGN. But it earns $5,500 per month by having Charleston Cable carry TBS. This $5,500 is the sum of $4,000 from subscribers earned by Charleston Cable from carrying TBS and $1,500 of advertising revenues earned by Turner Broadcasting directly from TBS broadcasts in Charleston.

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process cannot be augmented by integration of that monopolist with firms at other stages of the production process. Nor can additional monopoly power be created by vertical integration (Blair and Kaserman 1983, Bork 1978). Vertical integration occurs because it reduces the total cost of producing the final product.[14] If vertical integration is unable to produce, augment, extend, or strengthen monopoly power, and if it often generates production or distribution efficiencies, there is no reason to constrain vertical relationships in the name of consumer welfare (Posner 1981).

The danger of such restrictions on ownership is that they can be used to stifle efficient but politically non-influential producers in favor of less efficient but politically influential producers. More generally, politically influential producers can bias the exercise of government's regulatory power so that rivals are obliged to abandon efficient practices. In brief, antimonopoly regulations such as these are too frequently used to protect competitors rather than to protect competition.[15]

Cable Reregulation and the Public Interest

The Cable Act of 1992 will not make cable a better deal for consumers. A variety of interrelated reasons for this failure may be noted: (a) quality-reducing rate controls by municipal governments; (b) *ex parte* participation in the financial management of the companies by rent-seeking municipal governments; (c) admission of over-the-air broadcasters and other competitors to the "pie" of profits generated by cable operators; (d) property rights restrictions, such as new carriage requirements and horizontal and vertical ownership restrictions, engendering higher costs and inefficient behavior in the industry. Monopoly is the central problem in the supply and pricing of cable services and the Cable Act of 1992 is impotent in dealing with the problem.[16]

[14]A vast literature supports this proposition. See, e.g., Williamson (1985).

[15]U.S. antitrust laws have a long history of being used in this fashion. See Dewey (1990), and McChesney and Shughart (1995).

[16]It is interesting that some representatives of the cable industry itself place the problem at the door of monopoly provision. Nowhere is the anticompetitive nature of proposed legislation better expressed than in the comments of James P. Mooney (President and CEO of the National Cable Television Association) before the U.S. Senate in 1991. (Senate bill 12 closely paralleled the final act as passed). According to Mooney (1991: 156–57) "there is a fundamental paradox contained in the franchise renewal provisions of S.12. . . . On the one hand, S.12 seeks to promote competition and curb the "market power" which single cable franchises supposedly enjoy in certain markets. On the other hand, the bill reinforces the notion that there can and should be only one cable provider per community. Rather than encourage cities to invite a second cable system to overbuild the incumbent, S.12 focuses on revoking the incumbent's franchise in order to allow a new sole provider of

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While empirical evidence for the viability of competition in local cable markets is not conclusive, it is highly suggestive. Several researchers have developed compelling models of cable markets and of the impact of regulation in these markets (Mayo and Otsuka 1991). Other studies have focused on the impact of competition (i.e., overlapping cable operators) on price and output (Merline 1990). A recent study comparing monopoly and competitive municipal cable operators of similar technical and demographic characteristics found that competition generates substantial consumer benefits: Competition reduced monthly rates for basic and pay services by $3.21 and $1.15, respectively. The total potential gain to all consumers—estimating the effect of competition on all cable systems—was over $3.6 billion per year (Beil, et al. 1993). Competition is, lamentably, not part of the Cable Act of 1992. As such, its absence is a missed opportunity to promote the public interest. Elimination of the monopoly-granting power of local governments is requisite to any progress in efficient cost-based cable supply.

Few pieces of legislation, however, are neutral in effect; the Cable Act of 1992 is no exception. This legislation introduces new problems within the context of monopolized local cable-service provision. In addition to those related to quality determination and rent seeking, new regulations introduce greater uncertainty into local cable businesses. Public and consumer interests are thwarted not only by direct municipal rate and franchise control; such interests are subverted in a far more indirect manner by the uncertainty that regulation creates among actual and potential franchisees. New and incredibly detailed franchise-renewal provisions give cities virtual carte blanche in manipulating franchisees and in limiting due process in franchise-renewal proceedings.

Such provisions, along with the politically controlled pricing system that is reintroduced into cable markets, will curtail further innovations in cable technology and programming investments. The intent of Congress in passing the Cable Act of 1984, which was to unleash cable technology by providing more revenue to cable operators and

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cable service into the community. The premise that one should replace one cable company sequentially with another is false: the Cable Act allows for several cable franchises in the same area at the same time. *It is the cities, not cable companies, which are perpetuating the 'monopoly' characteristics of some cable franchises, and S.12 reinforces the perception that there can and should be only one cable franchisee per community*" [emphasis added]. Mooney argues further that what the municipalities want is "the authority to throw out incumbent cable operators at will in order to hold auctions for their cable franchises. The net effect will be to extort maximum financial benefits from each bidder, not encourage competition."

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by assuring rate-setting flexibility to individual cable companies, is negated by the passage of the 1992 act. Cable operators have far less incentive to invest in plant and equipment or to innovate in providing new and better programming.

Nevertheless, over the long run there are some hopeful signs for the larger communications industry. The wired "information superhighway" is now operationally and technologically feasible. While much controversy surrounds the nature of the evolving system, Vice-President Al Gore (speaking for the Clinton administration) has proposed amending Title VII of the Communications Act of 1934. These proposed amendments would permit companies "to avoid the danger of conflicting or duplicative regulatory burdens" in the provision of telephone, video, and other information services (Flint and McAvoy 1994).

The Clinton administration's proposal would pave the way for cable entry into local telephone service by pre-empting state barriers and other encumbrances into local telephone markets. Similarly, it would eliminate state entry barriers to local telephone competition, as well as do away with FCC regulation of competitors that lack market power. The *quid pro quo* of the proposed deregulation is the proviso that open access be made available to all programmers on a non-discriminatory basis.

These sentiments are encouraging for the telecommunications industry in general, but the mistakes and anti-competitive bias of contemporary cable regulation must be avoided. The fact is that, despite 30 years of regulatory experience with cable television, no political or economic consensus has emerged on the nature and characteristics of that industry. Deregulation of the industry in 1984, which took full effect in 1987, was partial in that rate deregulation was not accompanied by the allowance of open competition in the vast majority of municipal markets. The impact of this deregulation on consumer welfare was ambiguous because most local governments, though not obliged by law to do so, continued to award exclusive franchises and to extract wealth in the form of cash and non-price concessions from the producers of cable services. Our study of recent and current legislation suggests that such approaches have been politically motivated and will fail to produce an industry geared to consumers' interests as long as politicians are running the show.

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Economic Reform and Private Sector Development in Russia and Mexico

R. Sean Randolph

In 1987 two nations of critical importance to the United States, Russia and Mexico, embarked on the path of ambitious economic reform. Though marked by different historical, cultural and political legacies, both nations were impelled to act by global political and economic movements that have placed market mechanisms at the center of an increasingly integrated and competitive international economy. In this emerging order efficiency, productivity, and private investment are increasingly recognized as effective—and therefore preferred—determinants of national progress and economic development. In contrast, the icons of the communist and socialist state systems—central planning, state industries, autarchic economic structures and massive administrative bureaucracies—have come to be perceived as impediments to growth and national economic security.

Responding to this challenge, the policies promoted by Russia and Mexico both seek efficient, market-based systems that provide improved social welfare and integration with the world economy. To achieve this, they have adopted measures that are now the standard arsenal of economic reform regimes worldwide, such as privatization, the decollectivization of agriculture, and the lowering of domestic barriers to trade and foreign investment. The results of their efforts, however, differ. While comparisons between nations with different historical antecedents must be approached with caution, a number of critical policy challenges are shared by economic reform programs worldwide. Even where the nature of the steps taken by reform governments are similar (such as price liberalization and the sale of state enterprises) factors such as the pace and sequencing of reforms

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and the enlisting of public support can radically affect the outcome. Due largely to differences in how reform has been managed, Russia and Mexico find themselves on the threshold of different economic futures: Mexico showing considerable promise and Russia facing continued peril and long-term uncertainty. A comparison of the choices taken in Russia and Mexico indicates a number of the key requirements for the successful reform of centralized economies.

Russia—Reforming the State

Economic reform in the USSR was commenced in haphazard fashion under Mikhail Gorbachev, who deserves due credit for initiating the transition to a market economy. Financial reform was begun with the authorization of private and cooperative commercial banks, and incipient domestic securities and commodities exchanges. Industrial managers were given new authority and farmers were encouraged to lease land for production outside the system of state and collective farms. In foreign commerce, businesses were permitted to trade directly, ending the state's historic monopoly. Modest steps were also taken to dilute the state's exclusive ownership of property. The effectiveness of these steps was seriously compromised, however, by Gorbachev's equivocation regarding the pace and ultimate objectives of reform. Despite pledges to "radicalize economic reform," scant progress was made toward the privatization of state industries, and throughout Gorbachev's tenure production remained closely tied to central plans, leaving little real scope for market forces to take root. When confronted with the political pressures that accompany truly radical reform, Gorbachev hesitated. Numerous economic plans were considered, only to be dropped. Most critically, he stopped short of an explicit recognition of private property rights.

The demise of the Soviet Union in the fall of 1991 gave Boris Yeltsin and the Russian Federation new latitude to pursue truly far-reaching reform. Compared to Gorbachev, Yeltsin moved forcefully. Leaders committed to deep reform, such as Yegor Gaidar, Boris Fedorov, and Anatoly Chubais were appointed to the government. Prices were freed and sustained attempts made to reduce government spending, restrain growth in the money supply, and stabilize the ruble. Political resistance in the parliament and conflict over spending with the Central Bank undermined the effectiveness of these measures, and the lack of clear direction on the government's part continues to hamper reform. There is little doubt, however, of Russian government's commitment to major systemic change.

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Agricultural and Industrial Privatization

In December 1991, Yeltsin launched land reforms designed to give farmers the right to rent, mortgage or exchange land; state and collective farm workers were given the right to land ownership. Since then over 22 million acres of land have been distributed free, including 13.5 million to small farmers. Because of parliamentary resistance, however, this policy was based only on decrees and was not based on a clear constitutional right to own, buy or sell land. As a result, the overwhelming share of agricultural land remains concentrated in state and collective farms, and limits on property transfer through sale or inheritance (resale is barred for at least five years) have forestalled a true free market for land. While many state farms have nominally re-registered as collectives and the number of independent farms has increased, Russian agriculture remains heavily dependent on state subsidies and distribution. In contrast, the recently granted right of individual Russians to own up to 1/4 acre and to buy and sell apartments has stimulated a growing market in residential property and a related construction boom. As a result, the supply of homes for sale around Moscow has tripled and the number of lots available has risen from zero to the thousands. A similar, if less dramatic, trend is underway in other Russian cities (Bohlen 1993).

More impressive progress is being made in the privatization of business and industrial enterprises. This has taken place through a variety of vehicles that include direct sales to employees, and sales to a combination of employees and outside investors through auctions and commercial tenders. At least 29 percent of each enterprise's stock must be sold at public auction. Most industries, however, remain in the hands of the existing workers and management, and the government will continue to maintain a large stake in many enterprises for a transitional period. Auctions of small and medium enterprises in services, trade, industry and transportation began in April 1992. By June 1993 more than 60,000 of Russia's 200,000 state-owned enterprises, mostly small businesses, had been sold, including half of all retail shops, restaurants and service establishments. The second phase of privatization involved larger industries; during 1993 over 8,000 middle-sized enterprises were sold. By early 1994, over 20 percent of all workers and 40 percent of workers in manufacturing were employed in privatized companies.

1993 saw the implementation of Yeltsin's program to divest large-scale industry through the redemption of 144 million vouchers issued to Russian citizens. Through that process most large enterprises have been converted to joint stock companies, as a precursor to the sale of shares. Voucher auctions for the sale of 7,500 enterprises employing

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8 million people were completed during the first year of the program (Privalov and Kalinichenko 1994). The voucher phase of privatization was completed in July 1994 (future privatizations will require cash bids), with mixed but generally positive results. By June 30, 1994, 70 percent of all industrial enterprises in Russia were privatized.

Inflation ravaged the initial value of vouchers, while speculation, fraud, and lack of hard information on the companies being privatized also undermined their value. Nevertheless, over 14,000 large and medium enterprises have been put in private hands, 1 million new small businesses are operating, and at least 40 million Russians now own shares. Though failures will inevitably occur and significant structural problems remain, the voucher system has given Russians a direct stake in reform and will help to provide an element of financial and managerial accountability that has heretofore been lacking. It will also stimulate Russia's fledgling stock exchanges, which have struggled with illiquidity and a dearth of tradeable assets (Tanayev 1992).

Although the private and cooperative sector's share of employment is rising, because of the way in which privatized assets have been distributed state industries still account for a preponderant share of production. Moreover, the continued concentration of ownership in the hands of existing management and workers threatens to perpetuate Russia's monopolistic industrial structure, continuing to distort price and production signals. Thus, when prices were freed in 1992, the concentration of production in the hands of monopoly producers produced major price surges. Despite the existence of a state committee on anti-monopoly policy and a law on competition and the restricting of monopoly activity on commodity markets, the committee lacks the political power to challenge Russia's entrenched economic and bureaucratic interests. To ensure price competition, privatization must produce change not only in the titular ownership of industry, but a diversification of a nation's underlying economic structure.

Some of the most innovative steps have taken place at the municipal level, such as the World Bank-supported program in Nizhny Novgorod (Imse 1993). There, one device used to address this problem has been the forced sale of assets by companies undergoing privatization. This was done in the deregulation of trucking, where state trucking enterprises were each required to sell 20 percent of their fleet in open auction. This had the effect of producing a body of private truck owners capable of competing with established enterprises (Borodachev 1993). Nizhny Novgorod is also experimenting with agricultural reform through a pilot program in which collective farms are dismantled and occupants issued title certificates permitting them to acquire both land and equipment at auction.

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Preference is given to current occupants, valuation of land and equipment and the allocation of the certificates is transparent, and decisions on how to organize production (either as individual farms or as partnerships) is left to the bidders. The Nizhny Novgorod experiment was authorized by Presidential decree in December 1992, as a laboratory of reform. Because of their ambitious pace, these measures were not immediately applied on a nationwide basis (though this is currently being considered). If this occurs, however, the process will be complex, as the Nizhny Novgorod program runs counter in spirit to other government programs that envisage large subsidies and a continued leading role for collectives and cooperative farms in the agricultural sector (Kotelnikova 1994).

Private Property and Constitutional Reform

After the parliamentary crisis of October 1993 another Yeltsin decree finally eliminated restrictions on the private ownership of land, authorizing the buying, selling and mortgaging of farm land and clearing the way for the breakup of large collective farms. More importantly, the new Constitution approved by national referendum in December 1993 specifically affirms the right to private property. Despite the mixed political signals sent by those elections (which also produced a large conservative-nationalist parliamentary bloc) the formal recognition of private property rights was a pivotal event whose implications for the development of a stable market economy are far reaching.

No clear rules yet exist to govern how property is bought and sold or how property rights are recorded and enforced, limiting the immediate impact of the constitutional change. Establishing a legal right to property does, however, play a more subtle role in supporting the development of the private sector, by providing a foundation for property rights that in recent years have been acquired on a de facto basis or under the authority of presidential decrees, but had never enjoyed clear legal status. A constitutional right to private property provides an important reassurance, in an environment of conflicting decrees and changing political alignments, of the irreversibility of reform and of the systemic legitimacy of private property transactions. This is an essential foundation for the private investment that business growth requires and for the functioning of a modern financial system in which assets can be securitized.

Complex, punitive taxes still impose a heavy burden on Russian entrepreneurs, undercutting the profit motive and the incentive for new business development. Beyond the problem of multiple overlapping taxes imposed by regions and municipalities, absolute levels of

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taxation approach confiscatory levels. In this respect, Russian policy is uncoordinated and internally conflicted, and runs counter to the larger objectives of privatization.

By maintaining high subsidies for state enterprises and by initially resisting the recognition of private property, Russia's Congress and Central Bank impeded the shift to a market economy, perpetuating both economic distortions and social pain. Despite this, privatization has remained a central element of the reform process, and despite persistent battles over economic policy has continued to advance at a relatively constant pace. Among its other beneficial effects, privatization is mitigating through new private sector employment much of the economic dislocation caused by market reforms. Significantly, following the resurgence of communist and bureaucratic forces in the government realignment of January 1994, the only major reformer to retain his cabinet post was Anatoly Chubais, the head of the privatization program.

Mexico—Freeing the Private Sector

Mexico presents a sharply contrasting picture. Beginning under President Miguel de la Madrid (1982–88) and with accelerating force under President Carlos Salinas de Gortari, Mexico has aggressively implemented privatization as the keystone to its market reforms.

Fiscal Discipline

Through fiscal discipline, inflation was reduced from 159 percent in 1987 to 8 percent in 1993, and the federal budget brought into balance. Public expenditures, less interest payments, have been reduced by a full 10 points of GDP and—through lower rates, a broadened base and strengthened enforcement—tax revenues have increased. Public sector debt dropped from 70 percent of GDP in 1987 to just 35 percent in 1993 (Sarmiento 1993).

Agricultural Reform and the Privatization of State Industry

Privatization was central to the Salinas strategy. The massive accumulation of assets and economic power in the hands of the Mexican government during the 1970s and 1980s had produced a large state sector whose continuing subsidization constituted a serious drain on the Mexican treasury. At the same time, private industry was protected from foreign competition by high tariff and non-tariff barriers. This produced widespread industrial inefficiency and a decline in both quality standards and competitiveness.

Mexico's privatization program began with the divestiture of small and medium-sized companies. This provided an initial base of experience.

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Next, the government turned to companies that required internal reorganization before being offered to the public. In some cases companies were merged, closed outright, or sold at token prices. Only after such internal evaluations were large-scale public sales commenced, under the management of commercial banks acting as the government's agents.

Initially conceived as a vehicle to reduce pressure on the federal budget—by reducing subsidies and generating income from asset sales—privatization subsequently came to be seen as the key means to improve competition within the national economy. Of 1,155 state-owned companies in 1982, 934 have been divested, leaving only 221 in government hands. Major sales have included the two leading airlines (Aeromexico and Mexicana), the telephone company (Telmex), steel, insurance, hotels, mines, shipbuilding, gas stations, movie studios, manufacturing, and the entire banking system. Workers at state enterprises have the option to participate in bids, leading to a substantial employee role in many privatized companies. The program is open to foreign investors, who have figured prominently in a number of major bids. Sales to date have netted the government $20.9 billion.

In a variation of privatization, Mexico has also become a world leader in the private development of public infrastructure. Since 1989 thirty-two build-operate-transfer projects have been launched, with 28 more on the drawing boards, in areas such as highways, ports, power generation, airports and water projects. In late 1993 Mexico ranked sixth in the world in the construction of toll roads through private resources, with concessions granted for projects covering 2,400 miles of roadway (Corona 1993). Legislation was also enacted in the summer of 1993 authorizing the private management of ports. This option is effectively substituting private resources where public funds are unavailable, accelerating the development of infrastructure needed to sustain broad-based economic growth.

In another move that challenged entrenched constituencies, Salinas in late 1991 began the reform of Mexico's system of 28,000 "ejidos", or communal farms. Dating to the Mexican Revolution of 1910 and occupying half of Mexico's arable land, ejidos have long suffered from a lack of credit, shrinking plot size and low productivity. Under Salinas' reforms, communal farmers are now able to buy, sell and rent farm land, and ejidos have the right to sell land to both domestic and foreign investors.

Opening Markets to Investment and Foreign Competition

The Mexican government is seeking to improve national welfare by building an economic base that is competitive at the global level.

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Opening Mexico's markets to foreign competition has been a key part of that process. Since 1982, when virtually all imports were subject to non-tariff barriers, import licensing has been eliminated and 80 percent of imports by value are free of quantitative restrictions. Tariffs have been reduced to a maximum of 20 percent, with a weighted average of 10 percent. While exports have been encouraged, most government export supports and subsidies have been eliminated.

To generate growth and service foreign debt, the government has aggressively courted foreign investment. Regulations were enacted in 1989 permitting 100 percent foreign ownership in most sectors, with automatic approval where investment is under $100 million. The number of industries limited to majority ownership by Mexican nationals has been reduced from 600 to 60. In 1994 Mexico's foreign investment law was formally revised to reflect these policies, reinforcing the stability of Mexico's investment climate. As a result of these measures, Mexico has attracted $33 billion in foreign capital since 1988, including $16 billion in foreign direct investment.

The Salinas administration's reforms have not been without cost, and their implementation has been less than perfect. A prolonged policy of tight credit (designed in part to attract continued foreign investment flows), when combined with new competition from imports, has bankrupted many small businesses and severely strained others. Much of the investment that Mexico has received is short-term and therefore vulnerable to withdrawal. While these inflows have financed Mexico's current account deficit they have also supported an overvalued currency, creating a potential source of instability. Financial problems have arisen in the toll road program. Nor are monopolies and favoritism a thing of the past. Unevenness in the distribution of the benefits of reform between wealthy and poor Mexicans and between Mexico's different regions could pose long-term problems if broad-based economic improvement falters. Nevertheless, the policy changes instituted since 1988 have on balance produced a broad-based rehabilitation of the Mexican economy, improving the quality and availability of goods and placing it on a competitive footing internationally. Most importantly, by fundamentally altering Mexico's economic structure the foundation for long-term growth has been laid, and the Mexican private sector has been given new freedom to lead the economy.

A Comparative Evaluation of Russian and Mexican Reform

Economic reform in Russia and Mexico is an effort to adjust—or in Russia's case to reverse—policies born of the two most epochal

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revolutionary movements of the twentieth century. Both Russia and Mexico entered the 1980s with a dominant political party, large bureaucracies, communally-based agricultural systems, large and inefficient parastatal sectors, government budgets burdened by high industrial subsidies, and inward-directed economic policies that restricted imports, limited competition, and discouraged foreign investment.

Because of the many historical and cultural differences between the two countries—the most important being Mexico's long and vibrant tradition of free enterprise—comparisons must be approached with caution. Nevertheless, a review of the strategies chosen by the Russian and Mexican governments reveals contrasting priorities that help to explain the relative success of the two reform programs.

Political Leadership

The success of Mexico's economic strategy has been supported by two critical elements. One is the boldness and comprehensiveness with which reform has been pursued. Salinas exerted strong personal and political leadership throughout the process, challenging even the most formidable political obstacles, interests or orthodoxies. Difficult political issues, such as reform of the ejidos or of the foreign investment law, were deferred but not avoided. In contrast to Salinas' boldness, the Soviet/Russian road to reform has been marked by uncertainty. Though begun at approximately the same time (1987), Gorbachev's approach was distinguished by a cautious incrementalism and a reluctance to fundamentally challenge existing economic structures; much of his term was spent attempting to improve or fine tune existing state mechanisms. As a result, the pain of transition was extended and the benefits of reform postponed, creating an economic limbo and breeding ground for political dissatisfaction. The foundation of a market economy—the development of a working private sector—was all but ignored until Yeltsin's presidency. This contrasts with Mexico's strategy, in which reform has focused on fostering an independent and competitive private sector.

Coherent government leadership in Russia has been in short supply. Where the Salinas government operated with a tight team of like-minded technocratic professionals, since January 1992 Russia has seen three prime ministers, four finance ministers, two central bank governors, two parliaments, two constitutions, and a stream of conflicting presidential decrees. The Russian public and business community, not to mention foreign businesses, can be forgiven if they are confused about the present or future direction of policy.

Procedural Fairness

Despite the social hardship produced by reform, the Mexican people have given a high measure of support to Salinas' programs. Although

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for many poorer Mexicans the standard of living has yet to improve, for many others the past six years have seen increased prosperity and a resumption in the real growth of personal income. What is politically critical in these circumstances is the public perception that change is required, that it is being managed equitably, and that measurable progress is being achieved. Because the Mexican government has largely met these criteria, hope and the belief in a better future have convinced the Mexican public to endure near-term hardship and have reinforced the political base for reform. As elevated expectatons of progress can be deflated by cyclical or other economic reversals, however, leadership, transparency and equity in the management of reform assume particular importance.

The critical importance of the political and social elements of reform has been acknowledged by Mexico's leadership. According to Pedro Aspe, "Confidence can rapidly disappear if the policies are not perceived as being consistent with the announced objectives . . . Government entities should be interested not only in bringing about better standards of living for the population, but also make them profound, on a day-in, day-out basis" (Aspe 1991: 23).

To maintain public confidence in privatization, procedural transparency is an absolute requirement. Any perception that the divesting of public assets will unfairly benefit special interests will undermine public acceptance of the burdens of reform. Although many of Mexico's privatized assets are owned by a relatively small elite, the policy continues to enjoy support because of the widely-shared view that the process has been fair and that its proceeds will benefit the nation (through new resources for social welfare and the retirement of public debt).

The lifting of price and foreign exchange controls and the removal of disciplines once imposed by the state's monopoly on power and resources have produced conditions of economic disorder that pose a direct threat to the Russian reform process. Support for reform is also being undermined by the widespread perception that the primary beneficiaries of reform are the old "nomenklatura" and criminal "mafia" who profit from illicit access to and manipulation of public resources. The Ministry of the Interior estimates that organized crime controls one-third of all turnover in goods and services; this directly affects the economy through increased prices, the cost of private security, and the discouragement of both domestic and foreign investment (Erlanger 1994). The popular view that, as in the former Soviet Union, privilege and connections permit a minority to benefit at public expense undermines support for legitimate entrepreneurship, and poses a direct challenge to the credibility and influence of reformers.

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Prioritizing Reforms

The Salinas administration also sequenced its program to make the components of reform mutually reinforcing. For example, revenues from privatization, reduced federal spending, and a policy of tight credit served to reduce inflation and support the value of the peso, creating an attractive environment for foreign investment. These foreign investment flows, in turn, have largely offset the current account deficit caused by rapid trade liberalization. The resulting balancing act can pose severe problems of economic management. For example, prolonged high interest rates, while helping to attract investment, can also starve small and medium industry of the capital it needs to invest and innovate. Likewise, to manage current account imbalances in the longer term, foreign and domestic investment must be rapidly translated into gains in productivity and exports. Careful sequencing is essential, since the benefits of action in one area can be easily diluted or offset by ill-timed decisions in another.

The sequencing and coordination of reform measures has posed particularly severe problems in Russia. Gorbachev's foot dragging on privatization and his procrastination over the issue of private property delayed the development of a true private sector and cost Russia precious years in creating a working market system. When prices were liberalized in 1992, therefore, Russia's underlying industrial structure remained highly monopolistic and prices surged. While entrepreneurs and workers have been encouraged to acquire state assets, confiscatory tax rates have all but eliminated legal (as opposed to black market) profits and the incentive for new investment. Expansive fiscal and credit policies stimulated by high industrial and agricultural subsidies have produced high inflation, undermining the process of economic stabilization. Macroeconomic stability is vital to private sector development, particularly in economies undergoing major structural reform.

Open Markets and Competition

The key to Mexican reform policy is its objective to increase national economic efficiency by stimulating the private sector. This is being achieved by stimulating domestic competition and by exposing Mexico's economy to global market forces. Mexico's entry into GATT in 1986 was a cornerstone of that strategy. Its 1989 negotiation of a free trade agreement with Chile, a 1993 free trade agreement with Colombia and Venezuela, and its successful pursuit of a North American Free Trade Agreement with the United States and Canada also reflect this approach.

In this strategy, Mexico has largely dismantled the system of import barriers and subsidies that protected the private sector. Despite the

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attention given to NAFTA, much of Mexico's import liberalization has been unilateral. Exports are being encouraged not by export subsidies but through broader measures designed to stimulate confidence within the Mexican business community. Competitiveness is also being stimulated by the withdrawal of the state from management of all but the most "strategic" sectors (petroleum), by deregulation (trucking and tourism), and by a more receptive attitude toward foreign investment.

In other words, while the Mexican government has led the reform process, it has done so not by generating new administrative programs but by creating an economic and regulatory environment that supports self-sustaining private sector growth. As Finance Minister Pedro Aspe, a principal architect of Mexican reform, has observed, "A larger state is not necessarily a more capable state" (Aspe 1991: 23).

In Russia, privatization is taking place through both formal and informal processes. Only a fraction of the stock of privatized companies has been sold to the public; the balance (as much as 70 percent) remains in the hands of workers, existing management and the state. In this ownership structure the first priority of management is often to maintain its control position, while that of labor is to protect or increase wages; this does not necessarily lead to new investment or improved competitiveness. In many cases existing management has "privatized" unilaterally or has established parallel enterprises that have surreptitiously bled off state assets. In the context of privatization this equates to insider trading. Despite the questionable legitimacy of these processes, the result may be productive if it leads to a viable and independent private sector. Serious structural problems will persist, however, if the "new" enterprises are not exposed to a truly competitive environment or are sustained through protective import barriers and continued state subsidies.

At the international level, the Russian government shares with its Western counterparts an obvious vulnerability to lobbying by domestic industry for both subsidies and trade protection. Tariffs on a wide range of consumer imports were sharply increased during 1994. To the extent that imported goods are restricted from the Russian market, existing monopolies will be reinforced and competitive pressures that would in other circumstances stimulate improved quality and productivity will be suppressed.

Outlook

Challenges to Russian Reform

Because of the heavy legacy of central planning and the equivocal nature of reform under Gorbachev, Russia will continue to face serious

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hurdles in its effort to implement a working market economy. In an environment of political uncertainty and economic instability, the Russian government a must sustain the momentum of reform. Subsidies to industry must be withdrawn on a progressive but clear timetable, and politically effective regulatory mechanisms established to ensure fair trade, encourage price competition and discourage monopolies. Taxes must be made both more predictable and less burdensome to fledgling businesses. As a stimulus to competition, barriers to imports and foreign investment must also be reduced. In the process of converting state industries to private companies, new attention must be given to making management and directors more accountable by increasing the proportional authority of outside shareholders in privatized companies. Wherever possible, assets owned by privatizing companies should be partially dispersed so that new businesses can be created, competition encouraged, and monopolies diluted. In the agricultural sector, the Nizhny Novgorod model should be applied on a nationwide basis, and newly-confirmed constitutional land rights reinforced by a strengthened legal system for the registration and transfer of title.

Maintaining public support is also essential if long-term reform is to be sustained. As Vaclav Klaus, Prime Minister of the Czech Republic, has observed, "Systemic transformation is not an exercise in applied economics or in applied political science; it is a process which involves human beings" (Klaus 1993). It is critical therefore that the public component of reform be fully integrated into the government's reform strategy, and that public attitudes and concerns be addressed. The necessity of reform, together with its costs and objectives, must be communicated, and the government's vision clearly articulated.

One major hurdle facing reform is the fact that market economics and entrepreneurship are presently linked in Russian public perception with criminal activity, corruption and economic inequity. While this can partly be attributed to ingrained Soviet thinking, it frequently has a basis in fact. Crime in Russia has risen visibly, with corruption extending from organized criminal gangs to the police and government. This undermines the legitimacy of the reform process itself. As shown in Mexico, fairness and transparency influence public attitudes and the time and latitude that will be given the government to achieve its long-term goals. To achieve this, strengthening the rule of law is essential. Continued privatization and deregulation can also have an impact in this area, by shifting more of the economy into private hands and reducing the opportunities for corruption that are produced by the excessive concentration of economic power in official hands.

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The success achieved by ultra-nationalist and communist forces in the elections of December 1993 was a reminder that the future of Russian reform is far from certain. Among the ideas proposed by Vladimir Zhirinovsky are the maintenance of subsidies for state industries, the retention of large industry in state hands (in effect limiting privatization to small and medium enterprises), and continued state ownership of land. These ideas are shared in less extreme form by communists and many industrial managers, who continue to demand large subsidies and would welcome a return to some form of central planning (Zamyatin 1994). Such a relapse would only, however, produce continued stagnation and even greater instability.

Seeds of Success

In the end, a break in the umbilical cord between industry and the government must take place if reform is to become irreversible and self-responsibility in the management of enterprises firmly established. To achieve this, and because of its multiplier effects throughout Russia's economic and political structure, privatization must remain the principal engine of reform.

The current Russian debate over economic reform divides into two major camps: economic liberals who stress the need to control inflation and foster the private sector, and economic traditionalists who emphasize the need to preserve Russia's historic industrial and scientific base through subsidies and other centrally directed measures. Despite debilitating swings in the value of the ruble and plummeting production statistics, other more positive signs suggest that a market system is actually taking root. Official production figures address the state sector but do not take account of the private sector, which accounts for a growing share of economic activity; this under-reported private sector activity partly explains why official unemployment estimates have not risen more rapidly. Reported declines in production, though real, are also measured against historical production figures that were inflated to meet central production quotas. Retail activity has been remarkably steady, suggesting again that official measurements of production under-report the effects of private economic activity.

Despite an array of problems, Russia's privatization can be judged a relative success. GUM, the once-shabby government department store, provides a good example of the benefits of both privatization and market opening. With over 18,000 shareholders, half of GUM's major co-owners are foreign investors. Since being privatized it has grown to become Russia's largest trading company and one of Russia's largest private enterprises. Profits grew eight fold in 1993 to R40 billion (Aspin 1994). Similar, if less visible, examples exist throughout

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Russia, as new entrepreneurs have risen to the surface and economic experimentation has occurred.

The development of a viable and self-sustaining private sector is the indispensable foundation of any market economy. Mexico's experience strongly points to the efficacy of a private sector-centered reform strategy. Continued progress in private sector development also holds the key to Russia's efforts to establish a market economy and restore economic and political stability. Long-term stability with growth cannot be achieved through monetary tools alone; it will also depend on a functioning private sector that both generates and responds to market signals. Other elements of an overall reform package (monetary policy, taxation, deregulation, etc.) must be directed and sequenced with the primary objective of reinforcing private sector development. Thus, for example, controlling the fiscal deficit is essential to maintaining stable prices, interest rates and exchange rates—all preconditions for a healthy private sector. The reduction of subsidies, taxes, monetary growth and government deficits is also necessary to control inflation and create an environment that is favorable to business formation and long-term investment. Consistent, predictable, and mutually reinforcing macroeconomic policies are essential.

Privatization can help to relieve pressure on government budgets, but in the absence of competition it's ability to produce a healthy economy is limited. Economic reform must therefore focus not only on the transfer of assets from government hands, but on the dilution of monopolies and the exposure of privatized companies to both domestic and international competition.

Economic reform is also linked to political reform. While not a guarantee of democracy, market economies provide an environment that is conducive to it. Experience in Asia (Korea, Taiwan, Singapore, China) and in South America (Mexico, Chile, Peru) suggests that full democracy is not a prerequisite for the development of vibrant market systems. However, economic freedom leads to pressure for new political options and personal rights. This occurs through education, increased disposable income, travel, access to information, and the simple fact that life's more basic requirements (food, housing and health) have been met. By fostering an expanded middle class, economic reform strengthens the constituency for political as well as economic liberalization.

The priorities for political and economic reform vary from country to country, depending on historical and cultural circumstances. Nevertheless, as experience in Mexico and Russia demonstrates, concentration on institutional and administrative reform is a less effective vehicle for long-term economic reform than a well-conceived economic

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program designed to engender an independent, broad-based and self-sustaining private sector.

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The Rule of Forces, the Force of Rules

Anthony de Jasay

All is not well with our politics. Never before in history, perhaps with the exception of ancient Greece, has civil life been politicized to quite the same extent as today. It might appear that society should be better, more fully served by its government than ever before. Yet few would think that this is the case. The principal products of more intrusive, more caring, and more comprehensive politics seem to be disaffection with, and dysfunction of, government. Where the process has gone furthest, under "real existing socialism," failure reached staggering dimensions. But whether governments now profess to live by democratic or socialist precepts, or by the near-ubiquitous, ungainly crossbred of the two, their relations with the governed are sour.

The causes of this state of affairs are by now quite widely understood. They have become the commonplace wisdom of political science and political economy. The study of public choice convincingly explains why political decisions are biased toward self-defeating, perverse effects and suboptimal, "negative-sum" outcomes, and why we, as rational players in the political "game," nevertheless keep asking for more of the same. Given the rules of the game, any other outcome is unlikely as long as enough people behave prudentially, in the sense of maximizing some not wholly implausible combination of material ends. Selfless voters or suicidal politicians could, of course, produce less depressing solutions, but they seem to be a rather rare breed. Failing a wholesale change of hearts, one possible solution to the dilemma suggests itself: change the rules. Hence the rising interest in constitutions as they are, and as they should be.

Seeming to be close to a state of despair by the very public choice logic that he coinvented and whose workings no one grasps better than he, James Buchanan (1993: 1) put it pithily:

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> How could the constitutional framework be reformed so that players who advance generalized interests are rewarded rather than punished? . . . The response is clear. *The distributional elements in the political game must be eliminated.*

Who Gets What, Who Pays What?

Any constitution that would eliminate the distributional element would, in truth, abolish politics itself. The reason for holding that politics is quintessentially distributional is fairly simple. When all benefits and all related costs come in finely divisible pieces, rather than in great indivisible lumps, each person's benefit can be made contingent on his paying a price that fully covers the cost of production, including the cost of excluding nonpayers. Individuals, in free contractual or quasicontractual interactions, will then profitably produce reciprocal benefits for each other, each paying for what he receives. There is no need for any collective decisions. If, and only if, important indivisibilities exist or are felt to exist (e.g., on the grounds that if peace, justice or security from life's risks is to be produced at all, it must be produced for all at once), do some politics become inevitable. Though it is quite a step from "some politics" to the fully fledged state, it is basically from our "need" for indivisible public goods (of which public order is a special case) that many political thinkers derive the need for a coercive supreme authority. Costless, non-scarce goods call for no decisions; each can take as much as he wants, and so can the person coming after him. However, public goods that cost something to produce involve political cost-allocation and political benefit-sharing. No matter how austere a notion of "need" for such goods we adopt, even a bare night-watchman service assuring public safety must involve collectively deciding who shall bear what part of the cost. Setting a global standard for the common benefit to be provided is, no less inevitably, a political matter with distributional consequences. Seen broadly, these decisions affect not only the present, but prejudge the future, too, through the grant of unrequited rights ("entitlements") and the assignment of the corollary obligations to involuntary obligors. Within this view of politics, arguing that political choices must not be about distributions means to argue that political choices must simply cease to be made.

On a closer view, however, Buchanan's postulate turns out to be, not that questions of distribution should be purged from politics (which in strict logic would be a contradiction in terms), but that they should be resolved in conformity with the principle of "equal treatment" or generality, applicable in politics no less than in law. Buchanan (1994: 2) suggests that 18th-century constitutions duly gave

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effect to this requirement. However, I believe that such a view gives these constitutions more credit than, at least judging by the American experience, they can rightly claim. With the passage of time, the U.S. Constitution, far from enhancing the safeguards of property as its Lockean inspiration called for, has proved to be very apt to accommodate redistributive group politics and sanctimonious, busybody, legalistic modern American liberalism.

I will come back to the content of the equal treatment principle presently. For now, it suffices to note that, if the principle were true to the promise its name seems to hold out, it would not abolish politics, but would assuredly take out some of its appeal; for if equal treatment really meant what at first blush it seems to mean, its adoption would change the world. No longer could politics enable some to gain at the expense of others, no longer could majorities despoil minorities, no longer could organized groups take turns to exploit each other, trying to get from politics what the economics of property and contract denies them.

A constitution that succeeded to hold nonunanimous collective choices to the purportedly straight and narrow path of the equal treatment principle postulated by Buchanan would by the same token drastically lower the stakes in the political game. Most of the fun, and most of its point, would be gone; it would hardly be worth playing. Welfarism could not favor particular groups. Interventionism would be unable to pander to its natural constituency, the corporatist interests.[1] Constitutional rules effectively ensuring equal treatment would utterly transform the incentive structure of public life. The net effect would be a reversal of the trends of the last century or more, and the relative places of state and civil society would start moving back toward the classical liberal ideal. Can any constitution achieve this much? And can it, for that matter, achieve anything significant at all?

Contract or Vow?

There are only two ways of reaching nonunanimous collective decisions that are binding on all. One is for the greater force to prevail over the lesser, bending it to its will. It need not always twist the weaker party's arm, and humiliate it into open surrender. Mutual recognition of the relative forces often suffices to produce a semblance of unanimity. There is always a presumption in favor of avoiding actual tests of strength, for the use of force to bash one side into submission

[1]Politics would be left with one irreducible constituency, the diehard intellectuals who cannot help believing that one must "reinvent government," because social engineering is a force for good that must never willingly be surrendered.

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is costly to both sides. Also, the risk that bullying and arm-twisting get out of hand and escalate into a mutually wounding all-out fight is a deterrent to making too many controversial "social choices," and to multiplying them immoderately and even frivolously, simply because each one seems a good idea to the stronger party of the moment.[2]

At the same time, the stronger party to this shadow arm-twisting, or to the real fight, does not have much chance to remain the stronger faction for long. History tells us that shifting alliances usually preserve, or restore, rough balance between opposing coalitions. No group retains quasi-permanent superiority, if only because imbalances create incentives to break up coalitions, whose members are induced to change sides until a rough balance of power is reestablished.

Let us call this somewhat informal method of reaching decisions in the face of incompatible interests or preferences "the rule of forces." To this day, it is this rule that governs the *modus vivendi* in international relations. However, in medieval Europe, as well as in modernity until the emergence of an effective monopoly of the use of force in centralized nation-states, basically the same balance-of-power rule governed the respective spheres of decision. Principally, these spheres were concerned with the roles and prerogatives of the prince and the "live forces" of civil society, such as major feudal lords, the estates, and the leagues of towns, some of which were allied with the prince, while others opposed him as contentious issues arose. The "constitution," to the extent that it existed, was no more than a summary expression of the balance of these social forces.

The alternative to the "rule of forces" is the "force of rules." Under the former, collective decisions obey, roughly speaking, the will of that coalition within society which could beat, or is seen as capable of beating, the rest into submission by using armed force, economic power, or moral ascendancy.[3] The "force of rules," on the contrary, rests on a prior commitment by all the parties concerned to abide by unwelcome decisions provided they have been arrived at in a manner laid down and agreed upon in advance.[4] The "rule of forces" prevails in a Hobbesian world of two principals, government and society, in a partly cooperative, partly adversarial arm's length relation that has

[2]In contrast, collective decisionmaking by rule, when all have the duty peacefully to accept whatever comes out of the vote-counting machine, is not a deterrent but a positive incitation to social choicemaking: the risks of strife and rebellion are removed, only the victors' rewards remain.

[3]Though given the perceived capacity to do so, the need to use this force will seldom arise.

[4]Of course, this agreement must also be respected after the fact by all.

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the essential features of a tacit contract. In this state, the provisions of a constitution are substantive, for it is meant to lay down, though not in so many words, what government must and must not do if it is to earn obedience and avoid rebellion. The "force of rules" fits the fantasyland in which dwell the General Will of Rousseau and its successor, the to-be-maximized social welfare function of contemporary social choice theory. Here, government is not a principal, not a party to an implicit contract with society enforced by forces located on both sides. There is only one principal, society. Government is its subordinate agent. There is the usual principal-agent problem between them, but it is not of first-order significance. The purpose of the constitution is no longer to smooth the rough edges of an adversarial relation, but to elicit the General Will by specifying the procedure for identifying it. As we now prefer to say, it is to provide an agreed-upon method of "social preference-revelation and aggregation." Constitutional rules are thus invested with a putative moral force, since they are the instrument through which "social preference" manifests itself.

Two consequences follow as a matter of strict logical entailment from this distinction. One concerns the respective functions of the two types of constitution, the one resting on forces, the other on rules. Forces yield to each other, when they must, on matters of substance, but they need not bother about procedure. Procedure is unimportant unless a procedural decision has a foreseeable effect on a substantive result. In that case, however, the apparent matter of procedure is in reality a matter of substance, albeit once removed. Conversely, rules for deciding in advance which alternative shall be accepted by all as the "socially preferred" one are by the nature of the case procedural.[5] They say, or can be made to say, that if an alternative was selected by certain agreed upon rules about how selections are to be made, that alternative is to be taken *by* all as better *for* all *on balance* than any other that could have been selected but was not.

Procedural rules go with the democratic grain; substantive rules go against it. At first sight, there is something incongruous about the idea that society should adopt a constitution that rules out certain

[5]Norman Barry (1989: 279) notes that today liberalism is often interpreted "as embodying agreement to procedures irrespective of the outcomes that might emerge from them." This is the position Barry (1989: 277) attributes to Hayek, in that "there are no *substantive* limitations on what legislatures may do, only strict procedural ones" in Hayek's constitutional proposals. Substantive rules seek to prejudge "end-states," which is now widely held to be an illiberal ambition. Only procedure, "procedural justice" and "process" (as in "the peace process," as distinct from peace) are politically correct objectives. Here is another example of trendy jargon clouding thought. Barry's diagnosis seems regrettably exact.

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alternatives—for example, interference with the freedom of contract —since by doing so society may bind itself to choosing an alternative that, come some future day, it might not prefer. Though good enough sense can be made of such a resolution, it takes a mental and moral effort that may not always be forthcoming. Substantive rules that tangle up the social choice machinery in apparent self-contradictions of this kind, do not sit easily with democracy. I cannot think of a way of proving that he is right, but I unhesitatingly follow Buchanan (1994: 2–4) when he affirms that it is substantive, not procedural, rules that make a liberal constitution. I would wish, though, that he would press home this judgment a little more dogmatically than is his wont; for it touches a serious question about the systemic compatibility of democracy and liberalism. More on this presently.

The second consequence is that a constitution that is not the expression of some balance of power between principals who hold each other in check on specific matters, but a mechanical procedure for collective decisionmaking in all things, has the incentive structure of a vow ("a contract with oneself") rather than of a contract properly speaking. It may be that not all contracts are honored, but they are contingently enforceable, depending on the forces directly or indirectly interested in their fulfillment. (All who have occasion to rely on contracts have an indirect interest in any given contract being honored.) Vows may be kept, but they are not enforceable. "Society" might respect a constitutional "vow" stopping it, on some occasion, from choosing a tempting alternative. But should it wish to yield to the temptation, all it has to do is suspend, reinterpret, or amend its vow. There is no greater force protecting the integrity of a vow than the strength of character of the individual (or in our case "society") that made the vow. Assume that a procedurally proper decision is reached, e.g., by majority vote, whose substantive content would be unconstitutional, vow-breaking. The sole force that could be devoted to upholding the "vow" is, according to the rules, directed by the very procedural "social choice" that is proposing to break it. The case need never arise, for there are usually ways of twisting a political vow so as not to have to break it. But if such a case were to arise, it is hard to see what could be done about it, except to protest impotently or look the other way.

A constitution that rests on the "force of rules" rather than, as of old, on the "rule of forces", has something of the character of a benign confidence trick. It is respected by most, in the spirit of David Hume, as long as most believe that it is respected by most. But under majority rule, the trick must be adapted to the majority view, the majority taste, the majority interest. This is why, under the system of judicial

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review, constitutional rules *evolve*. Failing it, they could hardly survive. The changing fortunes of the "takings" clause and the commerce clause in American history are telling examples. The few existing constitutional rules that could have inconvenienced "social choice" have in time all been reinterpreted out of recognition. As an example, one need only reflect on the fact that Italy is constitutionally held to a balanced budget.[6]

Equal or Differential Treatment

Take, however, a substantive rule that looks powerful, has not (to my knowledge) been tried in application, and promises to change the whole perverse incentive structure of politics for the better, deflating its sphere of competence instead of inflating it as at present: the rule of equal treatment proposed by Buchanan (1994). Buchanan is aware that putting this principle into practice would pose many problems of detail. By and large, however, he clearly believes that it could be translated into readily understandable guidelines that governments would find hard to flout openly.

They would be forced, for instance, to impose taxes at uniform rates; differential rates among persons, organizations, locations, industries, products, or other possible classifications of taxable subjects, would be ruled out (Buchanan 1993: 5). At least formally, no less than four types of taxation, each with a uniform rate of its own, conform to this guideline. We could have a uniform lump sum tax on natural and legal persons alike; or a poll tax on all natural persons, rich and poor, and another lump sum tax on all legal persons, large or small; or a flat rate tax on all incomes, high or low; or a tax at a uniform rate on all capacities to pay (this would be our progressive income tax under a different name). Nevertheless, while all four tax regimes may appear uniform, it can be argued that they are, in fact, differential: they all treat some members of a given class of taxable subjects worse than others.

Another possible guideline mentioned by Buchanan would lay down uniform subsidies for every industry. However, a uniform subsidy on labor employed distributes state aid among industries one way, a subsidy on capital employed another way, one on physical output or sales yet another way. Analogous arguments can be found to show that guidelines meant to tighten the nexus between benefits from

[6]I owe this startling item of information to Antonio Martino. The Italian budget is, of course, balanced like every other by the proceeds of vigorous treasury borrowing. Everyone who votes for this state of affairs must be trusting that his children, when they grow up, will manage to shift the burden of debt to other people's children.

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public goods and their costs (e.g., "The region receiving the new major road should pay for it") can, given the political will, always be circumvented by unfalsifiable claims of large, bountiful external benefits. Financing more and more education, a benefit to local families and their children, from central rather than local revenues would be a likely result of heeding such claims—the same result we are apt to get anyway, without an equal treatment guideline.

The long and short of it is that every "equal" treatment is equal with respect to a selected category or class of cases and unequal with respect to another. Giving the same stipend to all able or all deserving students treats all able or all deserving students equally, but treats all students—some of whom are not able and not deserving—unequally. Equal treatment of all poor old people is unequal treatment of all old people (poor and rich) and of all poor people (young and old). The inequalities generated by achieving equality for some category of subjects or cases are countless. Their number depends only on the richness of our vocabulary for formulating ever more and finer categories, within each of which the same treatment must be accorded to all.

Of course we have known since Aristotle that what we call equality is really equiproportionality, a fixed ratio between every member of one class of entities and every member of another class. A uniform proportion between each member of the class "families" and each member of the class "income dollars" yields "equal family incomes," but unequal "incomes per head," "per gainfully employed person," or "per dependent child." This is a relatively innocuous case of different distributional results being obtained by strictly adhering to "equal treatment", but shifting the reference class. One can trust the ingenuity of lobbyist lawyers and politicians worried about the next election to think up others whose distributional bite is sharper and deeper, while still conforming to some plausible construction of equal treatment and generality.

Choosing Procedure, Choosing Substance

A little more needs to be said about procedure, substance, and the prospects for a liberal constitution. Constitutional rules are not Moses's tablets. They are not made in heaven, and even if they were, men on earth would soon unmake them. It is a strange supposition that politics goes on within constitutional constraints, but that the constraints themselves are somehow above politics, determining it without being determined by it like any other product of collective decisionmaking. This is why, alas, no constitution is a "fixed" one. As values change, and views of how the world works—and the social forces associated

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with those views—change, constitutions also change. Either their letter is amended or their spirit (their "intent") is reinterpreted. No great technical difficulty obstructs these developments. Any obstacle to change—for instance, a restrictive rule protecting property from expropriation—is maintained because it is in the blocking minority's interest to have the rule. Its removal permits a redistributive gain whose value, in a world of no frictions and no "leaky buckets," approximates the value of the interest. The prospective gainers can buy off part of the opposing interest, (unblocking the blocking minority) and still have something left over. Relaxing the rule that protects property releases resources whose new distribution can dominate, politically defeat the old, in the same way as every existing distribution can be defeated by a new redistributive bargain, in obedience to society's apparently circular preference rankings.

Each set of constitutional rules permits an associated maximum of redistributive gains to be made by a winning coalition. Under a liberal constitution, the greatest possible gain is likely to be relatively small. That it minimizes the scope for redistributive policies is, in fact, as good an operational definition of a liberal constitution as I can think of (though the reader will perhaps decry it as question-begging; for it supposes that constitutional limitation of the scope of redistribution is a feasible result). If it chooses according to the motivation usually attributed to it in modern political science, and notably in public choice theory, the winning coalition will seek to get the set of rules adopted that will maximize its potential redistributive gain. What is sauce for the goose is sauce for the gander. Choosing the rules that maximize the winners' gains from politics is fully on par with maximizing the gains once the rules are given. If the latter is a realistic assumption, so is the former, and thus we must say goodbye to the ideal of the minimal protective state.

Substance—a heavily redistributive state with everyone subsidizing everyone else, and strongly intrusive politics—can be "chosen" by choosing procedure. The smaller is the winning coalition that can decide a given issue in its favor, the greater is the residual losing coalition and, consequently, the greater is the total of spoils the winners can extract from the losers. Under democratic equality, where every person and his vote weighs the same as every other, the smallest possible winning coalition is one-half of the voters and a tie-breaker, the median voter. Hence the procedural rule that will best deliver the desired substantive result is one that makes a simple majority decisive for every issue. So does the analysis of constitutions show liberalism and democracy as inexorably divergent, like the up train and the down train, running in opposite directions on parallel tracks.

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COMMUNICATIONS

Buy Health, Not Health Care

Robin Hanson

U.S. per-capita spending on health care is at an unprecedented high. Fear that something is terribly wrong with our health care system is widespread, and proposals to nationalize the industry are even taken seriously.

Perhaps some simple change will do the trick, like relying less on insurance and employers as middlemen. But if we are willing to consider radical change, let me offer a different suggestion. We are buying the wrong thing. What we want is health, i.e., a long healthy life, but when we sit down and draw up a contract, what we buy is health *care*, i.e., a certain degree of attention from health care specialists.

Of course there is some relation between the two—a concerned health specialist can help us improve our health. But there is also a difference—when we reward our advisers just for giving advice, do they try hard enough to give the best advice they can find for a low price? Or are they satisfied to give costly mediocre advice that is also comforting, authoritative, and requires their further services?

In theory we have a variety of institutional mechanisms to deal with this so-called "agency" problem. Strong legally backed professions raise prices, but supposedly avoid "quacks." Malpractice law and internal professional review punish advisers from drifting too far from local standard practice. However, current legal practice is biased toward advising more expensive care, and all this may do too little to encourage the evolution of a better standard practice.

For patients with long-term contracts, Health Maintenance Organizations (HMOs) have an incentive to invest now to prevent future symptoms, at least when standard practice requires attending to those

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symptoms. But HMOs also have an incentive to minimize standard practice and comply only in form. In principle, published track records could help people choose their health advisers. But such records are not currently published, and arguably require expertise to interpret.

To avoid these doubts, perhaps we should try to contract more directly for "health," rather than "health care." Let us give our health advisers a strong and direct financial interest in our having a long and healthy life. If this interest is strong and direct enough, perhaps we can dispense with most health regulations and trust a competitive market to make the right choices. Contingency fees can provide such direct incentives for lawyers. Can we find something similar for doctors? Something more like the way Chinese doctors were supposedly once paid only during months their patients were well? I think we can.

How to Buy Health

Consider for the moment my desire to live through the next year. Imagine that I agree to follow the health advice of my life insurance company. That is, instead of having a single organization handle both my health care and my health insurance, as in a HMO, a single organization now handles both my health care and my life insurance. This Life Maintenance Organization (LMO) agrees to pay for all the health care they advise, and I agree to buy life insurance only from them. The result is that my LMO acquires a clear interest in making sure I get effective health care. The higher my chance of dying, the more it will cost them on average to pay off on the life insurance. Thus, the more insurance I buy, the better care they want to give me, and the lower my chance of dying. How much insurance I want to buy depends on how much I value lowering my risk of dying by another notch, i.e., on how much my life is worth to me. To promote other health goals, I can buy other kinds of insurance from my LMO. To increase my chance of remaining able-bodied, and not just alive, I should buy disability insurance. To avoid being disfigured, I should insure against that. To avoid pain, I should buy pain insurance, though pain might be hard to measure objectively.

Since LMOs are being paid directly for improved health, rather than the appearance of care, they should have better incentives to reduce waste and find more cost-effective procedures. As critics have suggested, this may result in more preventive care, more attention to lifestyle, less reliance on doctors for routine work, fewer yearly check-ups, and more non-traditional care. Or it might mean the opposite, if the critics are wrong. The point here is: either way, I win.

There are, however, two big problems with this approach. The first is that even though my life may be worth $10 million to me, most of

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the (huge) insurance premium to pay for this insurance would be wasted from my point of view—there probably is not one person to whom I would want to give this much money when I die. The other problem is moral hazard—heavy insurance may reduce my incentive to keep myself healthy, and may even create incentives for my relatives to try and hurt me. It might be a problem if I could only give my doctor a 50 percent interest in my life by taking away 50 percent of my own interest, or by giving a minus 50 percent interest to my relatives.

How to Buy Health, and Pay Less

To avoid the problems mentioned above I could join or contract with a "medical defense club" (MDC) to buy life insurance on me from the LMO. The MDC would pay the insurance premiums and it would be the beneficiary should I die. I would pay the MDC a copayment for their trouble, a payment which should be little more than the cost of the health care that the LMO provides for me. Extra costs over actual health care costs stem mainly from fluctuations in the number of clients who die each year, and difficulties in estimating each client's risk. For large enough organizations, these costs can be small.

If I could trust the MDC not to try to kill me or make side deals with the LMO, I should get quality health care from the LMO at a fraction of the cost of buying life insurance from the LMO directly. But can the MDCs be trusted? Probably, if some simple precautions are taken. MDCs might be simple open institutions—perhaps even "clubs" with open meetings and rotating amateur leaders—unable to effectively conspire. Alternatively, cryptographic anonymity might ensure they do not know who exactly I am. Or MDCs might be distant organizations, whose members promise never to set foot on my continent. Or I might split up the MDC role among many independent organizations, so no one of them had a strong negative interest in me. Or I might combine all of these precautions. Thus I might keep my 100 percent interest in my life, and give my LMO a 100 percent interest in my life, by also giving an MDC a minus 100 percent interest in my life. Institutional constraints would allow the LMO to act on their interest, but hopefully prevent the MDC from doing so.

This is what I envision: I would shop around for a solid (reinsured) LMO who offered a low premium for the amount I felt my life (and disability) was worth, who credibly estimated a high chance of my living, and who seemed convenient and pleasant to deal with. I would also need to trust them not to conspire with an MDC, and to act in

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good faith regarding details difficult to contract over. Given detailed information about my health and history (which losing bidders promise to forget), bidding LMOs would declare their estimate of my chance of death, an estimate backed up by statistics evaluating the accuracy and bias of their previous estimates. (Losing bidders should forfeit large bonds if caught not forgetting, or perhaps crypto-credentials could hide my identity from bidders.) Various MDCs would then bid (preferably to my cryptographic pseudoname) on the copayment they would each require, given this LMO, insurance amount, premium, and estimated probability of death. I would then pick one with a low price that I trusted to stay honest. With a reliable death estimate from the LMO, the competitive copayment is trivial to compute, and since picking this price is almost the only decision an MDC must make, simple open MDCs could be up to the task.

What would happen if I had different values for dying or becoming disabled at different future dates, or for dying in different ways? Then I could pick different insurance amounts to be paid if I died or became disabled on different future dates and in different ways. What would happen if I wanted to give my LMO an incentive to help me live past 70, yet wanted the freedom to switch LMOs in one year? Then I could give my current LMO a 100 percent interest in my whole future life, but constrain them so that they could not act to improve my health after this year (unless I renewed with them). If I then switched, the new LMO would get a 100 percent interest in me, the old LMO might still retain a 100 percent interest, and my MDC might then acquire a minus 200 percent interest in me (or I might get a new MDC also). I might allow any new LMO to instead buy their 100 percent interest from any old LMO instead of from an MDC, if they could agree on a price. But if not, each old LMO would have to hold onto their interest until expiration. The same would hold for MDCs.

Would there be a problem of adverse selection? While I should have little interest in deceiving an LMO about the kinds of care to give me, I might want to deceive them (before they offer their bids) about the total amount of care that they will find it in their interest to provide. If those better able to deceive (and unthreatened by possible resulting reputation loses) buy more health this way, average premiums will rise. Current health insurance deals with this problem in part through employer-based coverage, since people are reluctant to switch to an employer with better health coverage simply because of raised expectations about the amount of health care they will need. Similar approaches can work here. Group coverage or any other way to credibly commit to future levels of health coverage can reduce adverse selection when buying health from LMOs. Remaining distrust

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can be reduced by extra spending on obtaining health records, genetic tests, physicals, etc. Thus adverse selection need be no worse a problem here than in traditional approaches.

Getting There from Here

Is this too big a change to be considered any time soon? Perhaps, but we might move in this direction one step at a time. As HMOs become more common, standard practice levels of care may erode, raising concerns about HMO incentives. So a first step could be for some individuals to buy their life and disability insurance from their HMOs, instead of from other insurance companies. HMOs would then begin to internally adjust their employee incentive plans to reflect their new incentives. A next step could be to legalize MDCs, allowing individuals to cheaply buy more insurance than they need, and thereby strengthen the incentives of their health-care provider. Finally, various localities could experiment with relaxing medical regulations, such as doctor licensing, drug approval, or required benefits packages, hopefully verifying that direct incentives have substantially reduced the need for these costly indirect approaches.

While looming U.S. health care reforms are clearly not moving in the direction of this proposal, such reforms need not preclude this approach if local experimentation with health care contracts is allowed. For example, required benefits packages may restrict care-giver options, but improved care-giver incentives should help as long as some discretion remains.

If, however, centralized "health care alliances" allow only a few possible contracts for each geographic area, experimental bundlings of health insurance and life insurance are unlikely to be tried. In that case some other country would have to take the lead in health care contract innovation. In any case there are open issues left to explore, like how to measure disability and pain, how LMOs and MDCs can be organized internally, current and future legal restrictions, and how to get things started. But the basic idea, buying health instead of health care, seems worth a closer look.

Appendix: A Simple Model

The following simple model suggests that the above institution might give you the same sort of health care that you would give yourself if you were your own doctor.

Let x_i be the various efforts you might make, and w_j be the efforts your doctor might make to help prevent early death or disability. For

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example, you might exercise and avoid fatty foods, and your doctor might administer drugs, remove a wart, or just give advice.

Let q_k be the probability of and H_k be the resulting harm to you from different ways and times k of early death or disability. The probabilities q_k are functions of all x_i and w_j, but we can neglect the dependence of H_k on these efforts if total effort $\sum_i x_i + \sum_j w_j$ is small relative to your wealth.

Let us express x_i, w_j, H_k as cash equivalents. Then if you were your own doctor, your net loss would be

$$L = \sum_k q_k H_k + \sum_i x_i + \sum_j w_j. \tag{1}$$

If each q_k were strictly convex in all efforts x_i, w_j, then to minimize this loss you would want to pick the unique optimal set of x_i, w_j, that would satisfy conditions

$$\sum_k \frac{\partial q_k}{\partial x_i} H_k = \sum_k \frac{\partial q_k}{\partial w_j} H_k = -1 \tag{2}$$

if it were an interior optimum. (This strict convexity requires, among other things, a clear division of labor between which kind of actions are yours versus the doctor's responsibility.)

Instead of being your own doctor, assume you are a patient hiring a LMO (doctor) via an MDC as above, each with losses

$$L_{\text{YOU}} = \sum_k q_k H_k + \sum_i x_i + c \tag{3}$$

$$L_{\text{LMO}} = \sum_k q_k I_k + \sum_j w_j - f \tag{4}$$

$$L_{\text{MDC}} = -\sum_k q_k I_k - c + f \tag{5}$$

where c is the copayment you pay your MDC, f is the insurance premium your doctor charges, and I_k is the insurance amount due if you die or become disabled in way k.

Assume further that these parameters are chosen in the following manner. First you announce all I_k. Then, knowing I_k, two or more LMOs simultanously bid $f \in [0, F]$, with the lowest bidder becoming your LMO. Then, knowing I_k and f, two or more MDCs simultanously bid $c \in [0, C]$, with the lowest bidder becoming your MDC. Finally and simultanously, you privately choose efforts x_i, and your LMO privately chooses efforts w_j.

If the q_k functions are common knowledge, and common to all LMOs, then the unique subgame perfect equilibrium of this game is for you to pick $I_k = H_k$, for you and your doctor to pick efforts x_i, w_j

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to again satisfy the same optimality conditions in equation 2, and for the doctor and the MDC to have zero profits, so that $L_{LMO} = L_{MDC} = 0$. This implies $c = \Sigma_j w_j$.

I have not worked out a full incomplete information version of this game. But the following speculation seems quite plausible. First, if q_k varies across the LMOs, then the lowest-cost LMO should become your LMO. Second, MDCs actually do not need to know the q_k functions, just the value of $\Sigma_k q_k I_k$, given the optimum efforts x_i, w_j, and LMO track records could be good enough to allow MDCs to estimate this.

Finally, even if the q_k functions are not common knowledge between you and your MDC, the same outcome could be plausibly arise from an iterative process of adjustment. Each side (patients or doctors) really needs only to learn how death and disability rates depend on the parameters they control, given the current parameter choices of the other side. And if you did not know enough about the x_i-dependence of q_k to set x_i well, your LMO would have incentives to educate you, and you would have incentives to listen.

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A Primer on Clintonomics

William A. Niskanen

The 1994 *Economic Report*

The first *Economic Report* of a new administration has often been an important statement, especially following a change in the party of the president. The 1962 and 1982 *Reports*, for example, were among the best summaries, respectively, of the Keynesian perspective of the Kennedy administration and of the supply-side perspective of the Reagan administration. The 1994 *Report* is only slightly less important as a statement of both administration policy and economic theory, primarily because much of it represents a reprise of themes developed in the 1962 *Report*. For Clinton's Council of Economic Advisers (CEA) has endorsed a pervasively activist economic policy: one part Keynesian fine-tuning, one part microeconomic intervention to correct market failures, and one part redistributive—seasoned by a dash of youthful arrogance that smart people in high office can solve most any problem.

The Keynesian Virus

Clinton's message sets the theme for the 1994 *Report*: "As a result of our efforts, the economy is now on a path of rising output, increasing employment, and falling deficits." One might think that the current recovery started on Clinton's watch and that the rest of us were born yesterday. A more objective record would have acknowledged that the current recovery began in the spring of 1991 and that most economic conditions improved more during 1992 than during 1993

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TABLE 1

SUMMARY OF U.S. ECONOMIC CONDITIONS

	1992	1993
	Percentage Change	
Real GDP	3.7	3.1
Productivity	3.4	1.9
Employment	1.3	2.1
	Percentage Point Change	
Interest Rates		
3 months	−0.87	−0.17
30 years	−0.26	−1.19

(see Table 1). Only employment and long-term interest rates improved more rapidly in 1993 than in 1992, but long rates have since backed up to a higher level than when Clinton took office. Despite the rhetoric of Clinton's continued campaign, he inherited an economy well into a moderate recovery with low inflation.

The Keynesian virus is apparently incurable, but I was surprised to realize that there are still several surviving Keynesians under the age of 50. The macroeconomics of the 1994 *Report* is thoroughly Keynesian but is not without some complications. Our low long-term growth rate is attributed to low saving and investment, but weak short-term growth is blamed on excess saving. The weak early recovery from the 1990-91 recession, for example, is attributed in part to several conditions that may have shifted income to those with a higher marginal propensity to save. (Where is the black hole into which all this excess saving disappeared?) The explanation of why the spending cuts and tax increases in the 1993 budget agreement will increase economic growth but why additional measures to reduce the deficit would reduce growth is too torturous to describe.

The CEA should at least get the facts straight. The following is a selection of statements from the macro-chapter that are just not true:

- "... banks show new signs of wanting to make business loans." (Total commercial and industrial loans by commercial banks continued to decline through December 1993 to the lowest level in five years.)
- "Typically, the saving rate falls as recovery begins ..." (The saving rate increased in the first year of recovery from the recessions of 1949, 1960, 1970, 1980, and 1990.)

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- ". . . the 1980's saw a classical Keynesian, demand-driven expansion." (A demand-driven recovery is characterized by an increase in both output and inflation. The record peacetime recovery of the 1980s, in contrast, was marked by a substantial decline in inflation.)
- ". . . contrary to the supply-sider's claims, income tax cuts have generally *reduced* tax revenues." (This is one of the most persistent unfounded charges by the critics of Reaganomics. What supply-sider ever claimed otherwise? Where? When?)
- "Healthy gains in productivity . . . will be the key to keeping inflation tame." (That is backward: inflation, which is primarily a monetary phenomenon, somewhat reduces productivity growth. There is reason for more general concern when a government official now on the Fed attributes inflation to some nonmonetary condition.)

Keynesian economics seems to have evolved into a secular religion in which the facts are squeezed, tortured, and misrepresented to fit the theory. One wonders what happened to the CEA's vaunted fact-checking process.

Microeconomics with a Special Twist

Several other chapters reflect a broader consensus among economists but, in each case, with a special twist. Much of the chapter on developments in the U.S. labor market addresses the increasing wage premium to higher skills. That development is attributed primarily to conditions specific to the United States without mentioning that it is common to most of the major economies. The CEA, for example, dismisses the effect of trade liberalization on the wage distribution but attributes much of the increased variance of U.S. wages to the decline of union membership and the decline in the real minimum wage.

The chapter on microeconomic initiatives is generally sensible and summarizes a thoughtful approach to reform of the Superfund program. This chapter, however, is a bit gushy about the prospect for environmental and technological initiatives and stronger antitrust enforcement, a perspective that reflects more concern about market failures than to the potential for government failures.

The trade chapter includes some surprisingly critical language about the dumping provisions of U.S. trade law and a rather strained rationalization of increased U.S. trade pressure on Japan. The focus of Clinton's trade policy seems to be the opening of foreign markets by any means (hopefully) short of gunboats.

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Health Care: An Arrogant Policy of Redistribution

The CEA would have been best advised to avoid a public discussion of health policy, because the chapter on health care reform is as shameless as the Clinton health plan is arrogant. What is the evidence, for example, that "Tens of millions of Americans . . . live in constant fear of bankruptcy should they become ill"? The statement that "nearly 39 million people . . . were uninsured throughout 1992" is quite misleading; this estimate is specific to the number of uninsured at the time of the survey, most of whom were reinsured within six months. Health security is defined as guaranteed comprehensive health insurance, not access to medical care. Charging high-risk people a higher premium is described as a "shortcoming" of the private insurance market. The increase in health care costs is attributed to demographic and technological developments with little attention to the effects of broader third-party coverage. The chapter does not acknowledge the probable effects of the proposed controls on new drug prices, insurance premiums, and provider fees or the effects of the complex pattern of marginal tax rates on the labor market. Finally, the chapter endorses the fantasy that the Clinton health plan would not only substantially broaden health insurance but would also reduce the growth of health care prices and expenditures, increase real wages, and reduce the federal deficit.

One wonders why an administration needs a group of high-priced economists if their primary role is to parrot the party line.

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Understanding Riots

David D. Haddock and Daniel D. Polsby

After the Los Angeles riot in spring of 1992, almost every pundit in the country took a turn at explaining why riots occur. The conventional wisdom on the subject went something like this: certain dramatic events such as political assassinations or unpopular jury verdicts crystalize riots from social rage. So to understand riots, one must understand the causes of social rage, usually said to be racism, poverty, lack of economic opportunity, and why people who experience this rage manage it in such a destructive manner. The usual suspects include breakdown of the family, television, and a generalized cultural disorientation.

All of these explanations have some truth in them, but are evidently incomplete. First, they explain too much. The predisposing social conditions are with us all the time, yet riots are episodic. Second, they explain too little. Many mob actions, like European soccer riots or the increasingly predictable civil meltdowns in the home cities of National Basketball Association champions, are triggered by good news, and not obviously related to social injustice or existential anomie. Indeed, during the Los Angeles riots, anyone with a TV set could see that jubilation rather than fury best characterized the mood of the people in the streets. It is hard to credit that these exhilarated looters with their new VCR's and cameras were protesting the jury system, the state of race relations in Southern California, or anything else. They were, in fact, having a party. Moreover, many of those who risked life and limb opposing the more outrageous excesses of the rioters were themselves poor, unemployed, and victims of racism.

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Conversely, a crowd is not an incipient riot merely because it assembles a great many people with the predisposing demographic characteristics. For example, every Fourth of July in Chicago's Grant Park there is a fireworks display that usually attracts about a million spectators. In certain parts of the grounds, people are packed together like sardines, so that individuals substantially lose their ability to decide where to go. One goes where the crowd goes. Going against it is impossible, and even leaving it (unless one is near the edge) may be difficult. Some people dislike the experience, but whatever its discomforts, the Fourth of July crowd at Grant Park is not a riot in the making. The crowd is big, it is loud, it is unmanageable, it is filled with people who have suffered from racial discrimination and economic deprivation, it has, in aggregate, drunk a lot of beer (which is legally for sale at dozens of kiosks at the event); but it is only a crowd, not an incipient riot.

Day in and day out in any big city, police blotters will reflect the existence of a fairly steady background supply of theft, mugging, arson, and homicide. But this jumble of criminal mischief does not amount to a "riot"; riots are the *coordinated* acts of many people. If they are coordinated, who coordinates them? Authorities looking for ways to explain why trouble has broken out on their watch sometimes ascribe exaggerated organizational powers to "outside agitators." While, as we explain, there is definitely a leadership niche in the ecology of a mob, it seems to become important only after the crowd has assembled. Riots are not, as a rule, plotted and scripted affairs.

It would be very difficult indeed to "stage" a riot. A person who set out to do so would encounter a series of difficult challenges. When should the riot be held? Where? How should the participants be notified? Once marshaled, how should they be instigated to behave in a way that would expose them to arrest? Trying to organize a riot as though it were a company picnic would quickly attract the attention of the police. And with the police watching, who would be brave enough to cast the first stone?

How, then, do riots begin?

Assembling the Crowd

When something happens that causes a large number of riot-prone people to mass spontaneously in one place while police cannot mass at a correspondingly rapid rate, the cost of starting a riot, as any one participant would figure it before the fact, would begin to decrease dramatically. It would decrease still more if it seemed to a prospective troublemaker that his own hopes and expectations about the potential

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behavior of the crowd were also the hopes and expectations of many of its other members, because in that case it would seem a better bet that if he did cast the first stone, many others would follow.

The most obvious way to get a riotous crowd to assemble is the occurrence of what could be called a "Schelling incident," after Thomas Schelling, the great master of strategic theory. In *The Strategy of Conflict* (1960: 90) Schelling wrote,

> It is usually the essence of mob formation that the potential members have to know not only where and when to meet but just when to act so that they act in concert. Overt leadership solves the problem; but leadership can often be identified and eliminated by the authority trying to prevent mob action. In this case the mob's problem is to act in unison without overt leadership, to find some common signal that makes everyone confident that, if he acts on it, he will not be acting alone. The role of "incidents" can thus be seen as a coordinating role; it is a substitute for overt leadership and communication. Without something like an incident, it may be difficult to get action at all, since immunity requires that all know when to act together.

It is not crucial, in the generative stage of a riot, that the participants act literally simultaneously. What is crucial is that offenses occur rapidly enough to overwhelm the police. From the rioter's viewpoint, there is safety in numbers. There comes a point at which the police pass from inadequacy to impotence. In the Los Angeles riot, the police actually pulled back from the trouble when it became obvious to everyone, including themselves, that there was nothing constructive they could do.

Certain kinds of high-profile events have become traditional "starting signals" for civil disorders. In fact, incidents can become signals simply because they have been signals before. What ignited the first English soccer riot has been lost in the mists of history; but they had become a troublesome problem sometime during the nineteenth century, as Bill Buford (1991) makes clear in quoting old newspaper accounts in his *Among the Thugs*. Today, there is a century's weight of tradition behind soccer violence. People near a football ground on game day know that a certain amount of mischief, possibly of a quite violent kind, is apt to occur. Those who dislike that sort of thing had best take themselves elsewhere. Certain people, though, thrive on the action —relish getting drunk, fighting, smoking dope; enjoy the whiff of anarchy, harassing and beating respectable people and vandalizing their property. Such people—hooligans—make a point of being where the trouble is likely to start. The sort of "soccer fans" about whom Buford wrote were mostly interested in barbarian camaraderie,

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not soccer. Some of them do not even go inside the stadium, and some spectators do not watch the game but pass their time in petty thievery. Hooligans' game is being a part of the crowd that congregates near a soccer stadium, belonging to and sharing its power, especially its power to flout the law.

A Schelling incident is not a signal that tells a person what to do. It is a signal that tells a person what *other people* will *probably* do. In the United Kingdom even an ordinary minor league soccer match might well be a Schelling incident. Buford gives several examples. In the United States, that sort of game would not be—but having one's team win a National Basketball Association championship increasingly seems to be. In Detroit in recent years, "Devils Night" (the night before Halloween) has become a springboard for multiple, independent, almost simultaneous acts of arson. These are examples, baleful ones, of how culture, habit, and tradition can overcome major organizational barriers to cooperative social endeavors and lower the cost of transacting business.

As word spreads of a conventional triggering event—whether it is shocking (like an assassination) or rhapsodic (a three-peat)—crowds form spontaneously in various places, without any one person having to recruit them. Each member of the crowd will know more about the intentions of fellow crowd members than people usually know about the intentions of strangers, because once a starting signal has been given, people know that a riot is impending. They gather into crowds because they want to participate and they know why the other people in the crowd, or at least a great many of them, have come.

Not every crowd threatens to evolve into a riot. In fact, the opposite is more often true: people bent on criminal mischief usually do not want lots of witnesses and possibly hostile bystanders around when they commit crimes. And so the psychology of the crowd's members is crucial. A significant number of the crowd's members must expect and desire that the crowd will become riotous. That is, there has to be a critical mass of people in the crowd who are making accurate judgments, not about their own desires and intentions, but about the riotous desires and intentions of other members of the crowd.

The Role of the Entrepreneur

For a riot to begin, it is necessary but not sufficient that there be many people who want to riot and who believe that others want to riot too. One more hurdle has to be overcome. Even in an unstable gathering, the first perpetrator of a misdemeanor is at risk if the police are willing and able to zero in on him. Thus, someone has to serve

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as a catalyst—a sort of entrepreneur to get things going—in Buford's account usually by breaking a window (a signal that can be heard by many who do not see it).

In civil rights, anti-war or anti-abortion marches, it is probably pretty common to find participants eager to expose themselves to arrest in exchange for the chance to optimize the desired impact of their protest. This sort of self-sacrifice is certainly rare in ordinary riots, where potential rioters' behavior is consistent, we suppose, with something like the following calculation: "If somebody else gets the riot started, I can participate without much risk. But if I stick my neck out and nobody follows, I'll be the only one arrested. So I'll wait for somebody else to go first." If every would-be rioter reasoned thus, nobody would cast the first stone, and the riot would not ignite. This is a typical free-rider problem, as economists have called it. It is usually sufficient to prevent riots from occurring, even where there is a plentiful supply of disposed participants. Riots await events that surmount the free rider problem.

The entrepreneur will throw the first stone when he calculates that the risk that he will be apprehended for doing so has diminished to an acceptable level. The risk of arrest declines as a function of two variables—the size of the crowd relative to the police force available to control it, and the probability that others will follow if somebody leads. This latter point could potentially be tricky, because as we have noted, crowds will generally be inhospitable to the commission of violent acts. But it is possible for a crowd to telegraph its willingness to riot. Buford's account (1991: 81–85) of a soccer hooligan rampage in Turin furnishes an example. Members of the crowd marched themselves around in a spontaneous formation with a stilted, unnatural gait, chanting the name of their team. This unmistakable token of cohesion stopped well short of anything that the Italian police could plausibly charge as solicitation or incitement, but served to assure the members of the crowd that a critical mass had formed.

Sometimes a crowd will not clearly commit itself to riot, and in such instances an entrepreneur will take more of a risk getting things started. But if he has done his implicit calculations properly, once the first plate-glass window is broken, the looting will begin and will spread and continue until the civil authorities muster enough force to make the rioters believe that they once again face a realistic prospect of arrest.

The Formation of Action Nodes

As we saw in the case of Los Angeles, riots do not occur everywhere at once. Most of the homes and businesses in south-central L.A. and

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Koreatown (which cover a number of square miles) were untouched by the riot. Damage was concentrated at certain intersections and along certain strips, what we call "action nodes." How did the rioters know where these action nodes were?

Schelling (1960: 54–58) again offers a framework for analysis by offering powerful evidence for the existence of focal points in social life. People who may never have met are nonetheless capable of coordinating their behavior under some circumstances. In one experiment, two people were instructed to think of a number between one and ten and told that both would be paid a reward if each arrived at the same answer. Subjects' ability to psyche one another out far exceeded chance. Perhaps even more surprising, certain open-ended questions can elicit a high amount of agreement. For example, in one experiment Schelling asked his subjects what they would do if they were simply told to go and meet someone in New York City on a certain day. Out of all the possibilities for when and where to meet, a majority, trying to intuit where and when other people would expect them to be, would have converged at the information booth in Grand Central Station at high noon!

Nothing paranormal is reflected in these experiments. Although it goes beyond what is definitely known to say what makes for a focal point, some features do seem to emerge pretty clearly from Schelling's experiments. For one thing, *uniqueness* seems to be important. When asked to pick a point on a map to await another person with the same map but with whom no meeting place has been arranged, many people will select a house on a map with one house and many crossroads, but will select a crossroads on a map with one intersection but many houses. And, of course, uniqueness makes sense when selecting focal points. Even if both parties select a house in the latter instance, the chance that they will select the same house is small. If one of many houses is distinct, however, it may be selected by some participants—a single mansion may be selected as a focal point even on a map with many houses. Another element that seems to figure in establishing a focal point is what could be called *contextual prominence*—for example, the number "one" in a series of numbers, or the center of a circular area or a mountain rising from a plane.

We cannot say how a resident of South-Central L.A. might go about selecting a focal point. In fact it seems consistent with Schelling's experiments that there would have been a number of focal points, although substantially fewer than there were residents. For example, any of several major intersections, parks or schoolyards may have seemed the natural place for a large number of riot-disposed people to gather following the acquittals in *People v. Powell* (the original

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Rodney King beating case), which amounted to a Schelling incident at least in part because for weeks it had been advertised as such by TV and newspaper accounts of the trial.

One can hardly doubt that many residents of South-Central bent on making trouble arrived at places they expected to be "focal" only to find them largely deserted. But Schelling's work implies that a substantial number of others would have guessed right—would have gone to a major intersection, Korean strip-mall parking lot, or other public space and found the crowd they had expected to find nearing its critical mass—waiting for some of the outliers from non-viable focal points to find their way to more promising locations.

But here is a problem. Those who selected a non-viable focal point—in other words, those who guessed wrong—would now have to find out where everyone else went in order to join them. How did they get this information? Los Angeles' television stations' aggressive news coverage of the disturbance from its very beginning seems to have played a key role. Within minutes after the verdicts were announced in *Powell*, minicam crews were doing news "live from the scene," letting everyone in town know where the trouble was. Innocents thus learned what neighborhoods to avoid; but non-innocents, who wanted to take part in the looting, also found out where to go.

Although inadvertently, the stations lowered the search costs for aspiring rioters. Without TV, other techniques would surely have been used by people trying to find out where to go in order to loot and burn with little fear of arrest. But the broadcast media are by far the best way to get accurate information to many people at once. Especially in spread-out places like Los Angeles, rioting would be less likely to occur if information about the location of viable focal points were harder to come by.

Who Riots? The Role of Reputation

Although the conventional "racism-poverty-lack-of-opportunity" explanation is overly broad and somewhat shopworn, we do think it useful in explaining the makeup of a riotous crowd. Racism and poverty would clearly merit social concern even if they had no connection to people's disposition to engage in rioting. But these are indeed predisposing conditions. One seldom sees riots break out at a convention of orthodontists. Why?

Respectability—a reputation for behaving in a predictable, socially benign manner—is an extremely valuable asset for most people who live in the middle class world. It is one of the key ingredients in career and personal success, and the need for it serves as a sort of performance

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bond to keep middle class people in line. A person to whom respectability matters much should demand better odds before risking arrest and disgrace than would a football hooligan or a member of the American urban underclass or any other socially marginal character to whom respectability is of relatively little value. Such a person has something that a middle class person lacks—a great deal of nihilistic freedom of the "nothing to lose" variety. Such freedom, experience suggests, is a perplexing and often malignant possession. Any social policy that would materially improve the life chances of a potential rioter would concurrently raise the value of respectability to such a person, and thus dampen the incentive to participate in civil disorders. This is not to suggest that reputation matters less to a hooligan than it does to an orthodontist. The question is, reputation for *what*. A valuable reputation among the thugs is a reputation for hard partying, physical toughness, "sticking by your mates," and above all an ability to engage in predatory behavior without being arrested.

British football hooligans and members of American street gangs do not direct their aggressive behavior at members of their own group but only at outsiders. Reducing these individuals' disposition to violence would seem, therefore, to involve getting them to identify with the larger community—making them middle class, in other words. Alas, that is easier said than done. Many years of heavy social spending and a "war on poverty" have established that social and economic privations are very difficult to remove even in the long run, and in the short run can hardly be influenced at all. It follows, therefore, that riots are likely to be with us recurrently for the foreseeable future, and that the focus of public debate about riot management should concentrate on symptomatic remedies. Here, at least, some constructive ideas seem worth exploring.

Stopping a Riot

Once it gets started, rioting is difficult to stop by authorities as constrained as American police forces are. Indeed, two different kinds of constraints are important. The more obvious are the rules of constitutional law, that set stringent limits on how police officers may behave toward those whom they try to arrest. Second are the budgetary facts of life that guarantee that modern urban police forces will always be staffed well below peak load demand levels.

Both these constraints should affect the probability of riots occurring and their duration and severity if they do occur. Traditional deterrence theory teaches that in order to discourage crime at the margin, one or both of two things have to happen: either the probability of catching

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the offender has to be visibly increased, or the harshness of the consequences to the offender in case he is caught have to be tangibly enhanced. In the case of riots especially, there is not much that police forces can do about either option.

It is hard to imagine that the public would be willing to staff the police department at levels sufficient to deal with a riot immediately if one should break out: it costs a city's budget about $60,000 or more to add just one additional officer to the force. Nor will there ever be enough prosecutors to try every rioter that could be arrested, nor enough prisons to house them if convicted. Every rioter understands these practical constraints very well. They spell practical legal immunity so long as a riot continues.

If the police try to cover most of the serious action nodes that develop, they will be spread too thin to do much good anywhere. If they abandon some action nodes to concentrate on a few, the trouble can be stopped at the selected locations, but the procedure is like nailing Jell-o to the wall. The riot simply flows around the impediment and goes to locations the police have not covered. Until the National Guard arrives, quadrupling or quintupling available manpower and increasing the apparent risk of arrest, matters simply run out of control.

Of course authorities prepared to resort to brutality can terminate riots promptly. Buford gives the example of how the Sardinian police militia smothered a soccer riot during the 1990 World Cup matches. Hundreds of rowdy English soccer fans had flown in on chartered planes, and were determined to find trouble. The police did not try to cover every action node at once; this would have left them outnumbered everywhere. Instead, following textbook military strategy, they massed forces and surrounded first one, then another group of *hooligans inglisi*, rendering each in turn *hors de combat* by beating them senseless with truncheons. Few of the Englishmen actually had to be arrested (which would have been very time-consuming for the police). Nevertheless, because they were not allowed to innocently transpire through police lines to re-appear at some less well-defended action node, the riot soon collapsed.

No one would suggest that American police should emulate this style of riot control. And almost as objectionable for other reasons would be censoring television or radio news in order to impede the formation of action nodes. The Supreme Court has often stated (although not often acted upon) the principle that censorship for compelling reasons of national security does not offend the First Amendment. Even if this tenet is defensible in wartime, it stretches the point considerably to apply it to riots. Clearly there would be serious danger of political opportunism if authorities were permitted

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to interdict the flow of news merely because they asserted a fear that riots might otherwise ensue. Presently, every politically incorrect public manifestation would be subject to seizure or arrest. Such a thing actually happened in Chicago some years ago, when a gang of vigilante aldermen, on the unlikely premise that they were trying to forestall civil unrest, stormed an exhibition hall at the Art Institute and commandeered an oil painting that disparagingly portrayed the recently deceased Harold Washington, Chicago's first black mayor.

There is a third option, however, that might ultimately prove more palatable. According to our analysis the proximate trigger of a riot is an entrepreneur's calculation that he is unlikely to be arrested if he breaks a window. If as swiftly as they developed action nodes actually could be covered by the authorities, riots might not begin at all. Cities should consider how they might accomplish this objective. Experience has shown that the National Guard is not well adapted to the mission of early containment of a riot. It takes the Guard several days to get into action because when it is called, it is not merely foot soldiers that are summoned but their entire apparatus of logistics and command that must be mobilized as well. Moreover even the hint that authorities are thinking about calling out the National Guard could be seen as a provocative acknowledgement of a riot's incipiency. Public appeals that the Guard be summoned may therefore amount to a sort of focal incident and do almost as much to choreograph the beginning of a riot as to deter its occurrence. Of course once it gets into action the Guard does seem to pacify full-blown riots fairly swiftly. This fact suggests that sheer numbers of anti-riot personnel may be more important than tactics, training or other variables in quietening civil unrest.

For this reason cities might well consider the benefits of using a civilian auxiliary to reinforce and supplement the police force. Such a force could be deployed rapidly and demobilized just as fast once the trouble had died down because its command infrastructure, that of the municipal police, is always up and running. Of course it is out of the question for police departments permanently to maintain as many full-time officers as might be required by peak load demand. An analogy might be drawn to volunteer fire fighters, who receive training, though far less than their full-time professional counterparts, to enable them to meet contingencies too remote to justify commissioning full-time personnel. The original idea of the militia, as envisioned by the drafters of the United States Constitution, reflected something of the notion that ordinary citizens bore the final responsibility for the security of the communities in which they lived (Dowlut 1983: 93). When not burdened with a command and control

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superstructure but simply used to supplement law enforcement resources already in place, a modern equivalent to the militia might well serve to stop trouble before it started.

According to our analysis, riots are apt to be a more or less recurrent, if unpredictable, feature of social life. It is odd that our law enforcement apparatus seems to be designed for a world in which riots do *not* occur at all. With some imagination, public administrators could ensure that these destructive episodes become rare indeed.

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The Art of Forecasting: A Wager

Julian L. Simon

In his article "The Art of Forecasting: From Ancient to Modern Times" in the Spring/Summer 1992 issue of the *Cato Journal*, Donald M. McCloskey asserts that economists cannot make accurate forecasts. He likens forecasting to magic and divination, and he says it is dishonest to suggest that we can forecast better than the ancient readers of entrails.

For rhetorical purposes, Professor McCloskey says that if we could forecast, we would be putting our money where our mouths are. He takes the price of corn as his rethorical example.

Don McCloskey is not alone in thinking that economists cannot predict very well. The *Wall Street Journal*'s Lindley H. Clark is typical: "Economists have a great deal of trouble predicting the future, and it's unlikely that this unhappy situation ever will change" (19 January 1990: A10.) And in the above-mentioned issue of the *Cato Journal*, Leland Yeager quotes with approval Irving Kristol's "The beginning of wisdom . . . is to know that the future is unknowable" (Yeager 1992: 53).

Yes, economists—and everyone else, too—cannot predict *short-run* trends of interest rates, exchange rates, and security prices. This incapacity is well-established scientifically. But it is possible to forecast *long-run* trends with great reliability. Of course this is contrary to all common sense and common belief. "If it's so hard to be right about a decade, imagine the howlers in store a century hence," says the *Wall Street Journal* (11 January 1990: 1). And the *WSJ* quotes Martin Gardner, the famous writer about mathematical puzzles and scientific fallacies, as saying that prediction "is like a chess game. You can predict a couple of moves ahead, but it's almost impossible to predict 30 moves ahead" (11 January 1990: 1). That may be true for some

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matters, such as the weather and politics. But it is not true for economics.

As with many other matters, I entirely agree with McCloskey about the dangers that arise from government forecasts as they are usually made. Regretfully, however, I find that I disagree sharply with him on the ability of economists to forecast *any* significant events. The source of the disagreement is that he focuses on the short run, whereas I focus on the long run.

Paradoxically, it is much easier to forecast many matters for the long run than for the short run. And to meet McCloskey's test of honesty, I am indeed prepared to put my money where my mouth is, and I have done so in the past; the real problem is to find people who will wager on these matters. For example, I forecast that the price of corn (his example) will be lower in the future than in the present. The forecast will be more accurate the longer the period in the future, but I am willing to offer the wager even for only a year, though the odds in my favor then become very slight. Can we set something up, Don?

I would make such wagers in securities markets if they existed. But, there are no futures markets to accommodate the long-run wager.

Exactly the same offer holds for all other raw materials. And I will even extend the offer to all measures of material human welfare, in any community, for any future year.

Indeed, it is almost a sure-thing prediction—subject only to the qualification that there be no global war or political upheaval—that people in the future will live longer lives than they do now, with higher incomes and better standards of living, and the costs of natural resources will be lower than at present. These predictions are so certain because the very same predictions, made at all earlier times in history have turned out so. And sound theory explains these benign trends (see Simon 1995 [1981]).

Check for yourself: Though the stock market gyrates from day to day and week to week, its course from decade to decade is almost always upward. The story is the same in reverse with natural resources. Copper, iron, wheat, rice, sugar, and every other natural resource have fallen in price, and therefore risen in availability, throughout the 200 years of U.S. history, and over the thousands of years of human history wherever records exist.

This makes sense. The history of civilization is a history of increasing knowledge of how to produce goods more efficiently and cheaply. This goes hand-in-hand with liberty becoming more widespread, and with increased mobility and communication. All this progress is reflected in the long-run trends of human welfare.

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We could test Professor McCloskey's judgment against mine by asking if he will make a set of wagers with me for a variety of raw materials if I give him 51 to 49 odds for the period five years from now. (My suggesting an even-money wager would be no evidence for my confidence. If he pushes me very hard, he might even get better odds from me.) And an even longer-term wager is almost like shooting fish in a barrel—as I will bet Don McCloskey will agree after he thinks about the matter for two minutes.

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BOOK REVIEWS

The Privatization Process in Central Europe and **The Privatization Process in Russia, Ukraine, and the Baltic States**
Roman Frydman, Andrzej Rapaczynski, John S. Earle, et al.
Budapest, London, New York: Central European University Press, 1993, Vol. 1, 262 pp.; Vol. 2, 276 pp.

These two volumes are the first output of the Privatization Project of Central European University headed by Roman Frydman and Andrzej Rapaczynski and financed by the Soros Foundation. Project coordinators have been established in each of the countries discussed in these volumes; they oversee the compilation of detailed reports on the economic environment, the legal system, and the progress of privatization. Volume 1 examines the changes in Bulgaria, Czechoslovakia, Hungary, Poland, and Romania. Volume 2 focuses on Russia, Ukraine, Estonia, Latvia, and Lithuania. Without doubt these volumes represent the most important sources of data on the transformation process underway in East and Central Europe and the former Soviet Union yet published. Frydman, Rapaczynski, Earle, et al. should be congratulated for their tireless work in coordinating the Privatization Project and conveying their results in such an accessible manner to the scholarly and public policy community.

The importance of this work, however, does not lie just in the mountain of data provided. More important is the fact that the data provided is the *right* kind of data. Economists are notorious for their "thin" descriptions. Aggregate data, such as GDP or GNP, supposedly provide an accurate picture of the economic health of an economy without requiring an excursion through the details of everyday life. But such aggregate measures are woefully deficient.

This bias toward aggregate economics as opposed to detailed microeconomic analysis results in a general failure to examine the structure of economic interrelationships. "The consequence of [aggregate economics] is that in the statistical study of social phenomena," F. A. Hayek wrote, "the structures with which the theoretical social sciences are concerned actually disappear. Statistics may supply us with material from which we have to reproduce these structures, but it can tell us nothing about these structures themselves. In some fields this is immediately obvious as soon

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as it is stated. That the statistics of words can tell us nothing about the structure of language will hardly be denied. But although the contrary is sometimes suggested, the same holds no less true of other systematically concerned wholes such as, for example, the price system" (1952:108-09).

Hayek's argument was intended as a critique of aggregate economics as a method to study capitalism even under the best assumptions, i.e., assuming that market prices are equilibrium prices that reflect the full opportunity cost of using resources. The problem of aggregation is compounded in the former communist economies. Official prices in those command economies represented nothing more than arbitrary accounting figures. In addition, economic data were admittedly falsified.

Unfortunately, Western analysis of the Soviet-type economies was mostly directed at "fixing" the aggregate data. Techniques were developed to convert Soviet aggregate economic measures, such as Net Material Product, into something comparable to Western measures of GNP. This procedure, however, failed to capture Soviet reality. The fundamental problem with Western estimates of communist economic performance was not poor measurement techniques. The problem was, and remains to this day, that aggregate measures are no substitute for detailed microeconomic analysis of the legal, political and customary institutions of a society, and how the incentives and information engendered by those institutions guide human behavior.

Even with the collapse of the communist system, the search for better macroeconomic measurements continues to dominate analysis (see, for example, Paul Marer, et al., 1992). Moreover, some of the work that does pretend to provide a microeconomic analysis of the system and the transformation process still reflects the economists' penchant for "thin" description (see, for example, Blanchard, et al., 1991; 1993). What is needed, though, is a "thick" description of the social institutions (legal, political, and customary) that are undergoing transformation.

This is where the work of Frydman, Rapaczynski, Earle, et al. comes in. These are the first volumes to provide exactly the kind of data needed for increasing our understanding of the momentous changes in East and Central Europe and the former Soviet Union.

If I have any quibble with the volumes, it is that they do not provide more information on the de facto customary practices that govern everyday economic life, such as the extent of spontaneous privatization and the development of the private sector through *new* privately owned entities rather than privatized former state firms or shops—in other words, private sector *developments* rather than privatization. As the Russian economist Vitali Naishul has pointed out in several studies, effective common law claims to state-owned firms have already been made throughout Russia by the old management and/or workers. Attempts to repudiate these claims would be socially explosive. Moreover, it could be argued that spontaneous privatization, rather than being socially noxious, is actually very effective (once various public choice arguments

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concerning transitional gains traps and bureaucratic tendencies are accepted).

The authors, however, cannot be faulted for this gap in their reports on privatization. As they point out themselves, despite the wealth of anecdotal evidence, there simply is not much reliable data on spontaneous privatization. The focus of the volumes, moreover, is on the political and legal process of privatization, and not customary practice. The great strength of these volumes lies in the fact that nowhere else can one find a more comprehensive and up-to-date discussion of the politics and law governing privatization in the various countries.

The Privatization Process in Central Europe and *The Privatization Process in Russia, Ukraine and the Baltic States* are invaluable reference sources for anyone trying to find out about the momentous transformation now under way in East and Central Europe and the former Soviet Union (whether for business, political or scholarly reasons). The authors have produced the definitive source. The Project on Privatization is a perfect example of scholarly entrepreneurship. The project has filled a tremendous gap in the literature, and hopefully will spur economic scholars to delve even deeper into the social structure of these societies and pursue the kind of "thick" description (informed, of course, by sound economic theory) necessary to make sense out of the changes taking place in these economies. If these volumes are any indication, the continuing work of the Project on Privatization will set the standard for data collection in this area of research for the foreseeable future.

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Free to Hate: The Rise of the Right in Post-Communist Eastern Europe
Paul Hockenos
New York, London: Routledge, 1993, 332 pp.

Implicit in the title is the now all too painfully evident truism that the newly acquired freedom of Eastern Europe is double-edged: hatred has been unleashed alongside all the other human impulses—except more so.

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To hate or not to hate is no dilemma; hatred is self-righteously apodictic. And given the moral and semantic stench that is now polluting Eastern Europe, a variety of euphemisms of neo-fascist hue dress the basest instincts with deceptive decor. While the author focuses especially on Hungary, Romania, Poland, the former siamese-twin nation of Czechoslovakia, and Germany, he tries to find some common threads that apply throughout the former Soviet empire.

One common theme is the refuge of nationalism, which Hockenos explains, as does Erich Fromm, as a kind of "new submission [whereby] the individual relieves himself of the burdens of individuality and freedom." And surely one can understand the sense of terror that accompanied the cataclysmic change resulting from the end of communism, from the ubiquitous anarchy absent a judicial system worth the name, and the collapse of economies based on lies. Hatred is after all but a form of fear. The flight from the burden of self and choice, though deadly, is only natural.

Hockenos, the Central and Eastern European correspondent for *In These Times*, approaches his subject with empathy and commitment. He interviewed dozens of people in the countries that he visited since the fall of the Berlin Wall, and his insights are essentially accurate. He describes, for example, the various nuances within the Hungarian Democratic Forum, not overestimating the political clout of its infamous poet-playwright Istvan Csurka, the leader of its chauvinist wing. It is correct, as Hockenos explains, that the HDF is "typical of the emergent conservative ideologies throughout freshly liberated Eastern Europe [insofar as] an ethnic concept of the nation was the very cornerstone of [its] raison d'être." The HDF looked back on the golden age of Hungary's past—as did the Hungarian Party of National Unity, other even more virulent political groups in Romania, and the Christian National Union in Poland.

This fixation with history appears to play a palliative role, as a kind of fantasy at the expense of the "inferior" others, to distract one from the hard reality of choice and poverty, of one's common humanity. The pseudo-intellectual Czech group of Skinheads, for example, who call themselves the New Czech Unity, target their hatred especially at the "Gypsy parasites." So, incidentally, do virtually all other nationalist groups in East-Central Europe. This Unity campaign is coupled with an anti-alcohol and anti-drug attitude based loosely on Bohemian myths from the Middle Ages. Evidently, the group exemplifies a fairly widespread attempt at creating a moral context for behavior in a free world; but the attempt derails into bigotry, even violence.

Despite the relatively small number of politically active nationalist parties, their influence is considerable. Romania is a primary example, where the Party of National Unity together with the extreme Greater Romania Party and the neocommunist Socialist Labor Party have wielded the necessary power to form what is essentially a coalition with the ruling party of president Ion Iliescu (which is now somewhat disingenuously named the "Party for Social Democracy"). Hockenos does a commendable job of analyzing the complex political landscape in that Balkan country.

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In essence, the book succeeds well as a kind of travelogue that assesses seriously, if a bit impressionistically, the political landscape in Eastern Europe. Its major flaw rests primarily on a hopelessly confused definition of "the right." Hockenos acknowledges that the term is very complex, and notes that in the West the right has been identified with the ideals of the free market and individual freedom, citing Margaret Thatcher and Ronald Reagan as two prominent figures of the Western "right." By contrast, in the East, Hockenos points out, the right has decidedly authoritarian, even fascist overtones. So far so good. But having understood this divergence, Hockenos succumbs to complete confusion as he proceeds to create a denotation for the term so central to his subject.

He first states that he "feels that the democratic ideals of the CSCE [Conference on Security and Cooperation in Europe] Paris Charter are positive" (without explaining how that affects the definition of the term "right"); then he justifies his "omission of the likes of Reagan and Thatcher" (from the definition of the word "right"? Again, it isn't clear) by noting that this is "offset by the fact that they have few equivalents in Eastern Europe." By implication, this seems to mean that his definition of "the right" is not the Western sense. So one more or less knows what it is not. But then what is it, exactly?

To further illustrate his confusion, Hockenos offers the example of Czech Prime Minister Vaclav Klaus as a radical free marketeer in the Thatcherist mold with "a questionable commitment to human rights and democratic procedure." Nevertheless, he generously "decline[s] to put Klaus in the league of Eastern Europe's old school of nationalists and extreme rightists"—but with a qualification: "This is not to say," writes Hockenos, "that someone like Klaus or Reagan (or better yet Patrick Buchanan) couldn't overstep the line that I have drawn." Never mind that no such line is visible. And what would it mean even to refer to such a "line"? Does Hockenos mean to suggest that Klaus's classical liberalism is only a shade away from authoritarianism?

Indeed, to suggest even for a second that classical liberal economist Vaclav Klaus has anything at all in common with the virulent anti-market, xenophobic extreme nationalists is nothing short of silly. Klaus has never flinched from his commitment to classical natural rights, both civil and political. To be sure, he opposes labeling as "economic rights" the social benefits provided in most countries through the largess of government. And here evidently is the root of the problem. For Hockenos seems unfamiliar with the traditional distinction between negative and positive rights, collapsing both as "human rights," to which he feels committed. Accordingly, he seems incapable of understanding either Western conservative or libertarian thought (he does not, of course, use the latter term at all); and his analysis is based on philosophical quicksand.

His final chapter, appropriately called "Anti-semitism without Jews," offers a sad commentary on that lingering ancient problem in the aftermath of a Holocaust that has not been adequately explained within the lands where it actually happened. The distortion of history that took place under Marxism-Leninism touched the Jews as well. It dealt with their ancestral existence

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in Eastern Europe simply and lethally: by total silence—which was itself a kind of "final solution" that was in effect as devastating to the reality of Judaism as Nazi barbarism. The people of Eastern Europe today are thus unable to appreciate all of what happened, or why; they cannot quite fit themselves into the puzzle, and continue to harbor animosities against a people they never quite understood. But Hockenos does not end on a hopeless note, for there are lessons to be learned and progress is possible. He concludes: "The states that provide their minorities full political and cultural rights, that grant their peoples and regions more autonomy, that practice multiculturalism will in the long run be more democratic and stable." No classical liberal would disagree.

Juliana Geran Pilon
International Foundation for Electoral Systems

Property Rights and the Constitution: Shaping Society Through Land Use Regulation
Dennis J. Coyle
Albany, N.Y.: State University of New York Press, 1993, 382 pp.

From zoning's earliest days, the regulation of society through the regulation of land use has proved an irresistible temptation to many conservatives as well as to modern liberals.

The conservatives apparently were glad to relinquish judicial protection for private property rights in exchange for zoning protection for middle- and upper-middle-class residential and commercial districts. Thus the Supreme Court's imprimatur on sweeping land use controls in *Euclid v. Ambler Realty Company* (1926) was bestowed by Justice George Sutherland, a champion of freedom of contract and substantive due process. Sutherland's opinion, replete with references to the apartment house in the single-family residential neighborhood as a "mere parasite," casually analogized land use controls to nuisance regulation. Modern liberals, from the Progressive reformers on, happily anticipated that the slums would be eradicated and Utopia would arise not from individual initiative or even from the democratic vote of the people, but from the expert ministrations of scientifically trained city planners.

Almost seventy years after *Euclid,* we find that land use regulation has indeed been destructive of property rights and also has hindered upward mobility. In its local and statewide administration it combines the stupefaction of bureaucracy with occasional swerves of judicial adventurism. Nevertheless, regulation remains popular with suburban homeowners anxious to protect their principal investment. It also retains the loyalty of planners and elected officials who, like the apparatchicks of the Brezhnev era, have lost the true faith but recognize the path to self-advancement.

Dennis Coyle, who teaches in the Department of Politics at the Catholic University of America in Washington, D.C., retells the story with particular emphasis on the jurisprudence of California, New Jersey, and Pennsyl-

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vania during the 1980s. These states were selected as prototypical, he explains, because California courts displayed the most deference to legislative authority and the least protection for property rights, Pennsylvania was relatively supportive of property rights, and New Jersey's Supreme Court aggressively fought "exclusionary zoning."

Coyle begins with three brief chapters; a mostly utilitarian "Why Land Use Rights?," an introduction to "Land Use and Culture," and a lament on "The Demise of Landowner Rights." The heart of the book are three longer chapters on "Cultural Conflict in Pennsylvania and New Jersey," "California: Where Deference Reigns Supreme," and "The United States Supreme Court: Hesitant Steps toward the Protection of Landowner Rights." He ends with brief chapters on "Feudalism and Liberalism" and "Land, Culture, and the Constitution."

The book is a useful and quite readable introduction to American land use law from a largely libertarian perspective. Its tone is uniformly partisan but not overly querulous. The main virtue of *Property Rights and the Constitution* is that its relative brevity provides an accessible examination of the theoretical and ideological aspects of zoning and its more recent refinements that allow fewer uses of right and increase governmental discretion. In particular, the chapters on New Jersey and Pennsylvania and on California show how the characters of the individual judges and the political pressures around them led to the shaping of land use law in those bellwether jurisdictions.

Constitutional theory, rights theory, ideology, culture, and the detailed development of land use law in three states (with U.S. Supreme Court cases as a backdrop) is a heady mixture for any one volume. While brevity provides an accessible panorama, the disadvantage of a 260-page book (with appendices) of this scope is that no topic could be covered very thoroughly.

Given the limitations of space, I would have preferred to see a general tightening of style and a reduction of the overlap between the introductory and the closing chapters. A number of additions would have benefited the reader.

First, an early and systematic treatment of property rights theory from explicit natural law and utilitarian perspectives would give the reader a better basis on which to consider Coyle's ensuing discussion of jurisprudential arguments and cultural (i.e., "hierarchical," "libertarian," and "egalitarian") viewpoints.

In the discussion of U.S. Supreme Court cases, there is no mention of *Penn Central Transp. Co. v. City of New York* (1978). While it came before the decade of the 1980s, on which Coyle concentrates, *Penn Central* is the definitive statement of the Court's present (and almost ludicrously lenient) "balancing test" for determining when a taking occurs.

In the Pennsylvania materials, it would have been interesting if Coyle could have related some of the strange saga of *United Artists Theater Circuit, Inc. v. City of Philadelphia*. In July 1991 the Supreme Court of Pennsylvania held in a seminal opinion that the requirement that the

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owner undertake substantial expenditures to maintain the art deco facade of a theater amounted to an unconstitutional taking under the state constitution. An extensive hue and cry from planners and preservationists followed, which caused the court to withdraw its opinion. (Not until November 1993, after Coyle's book was published, did the court issue a replacement, in which it withdrew from its constitutional position and instead struck the historic designation on narrow statutory grounds.)

Coyle does a good job recounting the development of the New Jersey Supreme Court's *Mount Laurel* doctrine, which parlays the state constitution's "general welfare" clause into a state-wide affirmative action mandate for low- and moderate-income housing. He should have discussed, however, the extensive scholarly and journalistic empirical accounts of how poorly the scheme has worked. I must note also that, on page 80, Coyle unfairly suggested that New Jersey Chief Justice Robert Wilentz is far more solicitous of freedom of expression than property rights. Not so. In 1990, Wilentz ignominiously lost a suit in Federal District Court brought by the producers of the movie version of Tom Wolfe's "Bonfire of the Vanities." Wilentz had denied the producers the right to film in an old courthouse often used for that purpose, on the grounds that he objected to some of the book's portrayals.

Dennis Coyle has performed a valuable service in writing *Property Rights and the Constitution*. I look forward in his future work to an expansion of some of the themes to which he brought considerable enthusiasm in the present volume.

Steven J. Eagle
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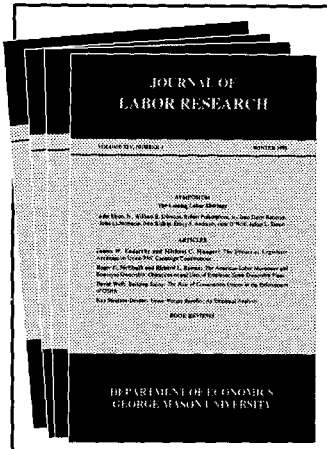

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—Mancur Olson

The Rise and Decline of Nations: Economic Growth, Stagflation, and Social Rigidities (New Haven, Conn.: Yale University Press, 1982), p. 175.

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